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BANK CAPITAL AND LIQUIDITY REGULATIONS PART II: INDUSTRY PERSPECTIVES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

SECOND SESSION

ON

CONTINUING EXAMINATION OF CAPITAL AND LIQUIDITY REQUIREMENTS APPLICABLE TO U.S. BANKS IN ACCORDANCE WITH THE BASEL INITIATIVES AND THE DODD-FRANK ACT, FOCUSING ON INDUSTRY PERSPECTIVES OF THE CURRENT CAPITAL AND LIQUIDITY REGIME AND THE EFFECTS IT MAY HAVE ON THE BANKING INDUSTRY, FINANCIAL STABILITY, AND THE ABILITY TO STIMULATE ECONOMIC GROWTH

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C O N T E N T S

THURSDAY, JUNE 23, 2016

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

BANK CAPITAL AND LIQUIDITY REGULATIONS PART II: INDUSTRY PERSPECTIVES

THURSDAY, JUNE 23, 2016

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:01 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Richard Shelby, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The Committee will come to order.

Today we will continue the Committee's examination of one of the most critical areas under its jurisdiction: the regulation of the U.S. banking system.

Recently, we heard from a panel of experts on the appropriateness and effects of capital and liquidity rules. Their testimony highlighted the complexity of the current capital and liquidity regime.

One witness testified, and I will quote, that " . . . we have introduced all these very complicated rules that tell bankers how to, in essence, be a banker."

We should be able to agree that regulators should regulate banks but not run them. Some believe that every one of the new capital and liquidity regulations is needed to guard against the next crisis. I worry that such complexity could contribute to the next crisis.

Regulators continue to reference the last financial crisis as a justification for rule after rule, without establishing a requisite nexus between individual rules and how they will prevent the next crisis.

This has created a vastly complex regulatory system that could increase systemic risk, while giving a false sense of security that the system is safer than it really is.

For years, I have urged regulators to implement strong capital requirements. I believe strong capital is essential for a sound banking system and as a safeguard against taxpayer bailouts.

Many have questioned whether recent capital and liquidity rules will actually work during the next crisis. For example, will they ensure that liquidity is available when it is needed? Or will they jeopardize the financial standing of an otherwise healthy bank?

In addition, no regulator has engaged in a rigorous economic analysis to identify the effect of regulations on funding and liquidity when a crisis strikes.

On one hand, regulators stress-test banks annually to determine whether the banks can withstand adverse economic scenarios. On

the other hand, they are unwilling to stress-test their own capital and liquidity rules to see whether these rules will result in more or less liquidity should a crisis occur. We simply do not know if these rules are tailored appropriately to both prevent and to handle the next financial crisis.

The purpose of today's hearing is to receive testimony from industry representatives. We have asked them to discuss the current capital and liquidity regime and the effects it may have on the banking industry, financial stability, and the ability to stimulate economic growth.

Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. I appreciate this hearing today. I thank all four of our witnesses for joining us. We look forward to your testimony and your answering our questions.

Two weeks ago, we heard academics' views on capital regulations, and today we hear the banks' views. It is good we are hearing from different perspectives. I appreciate the breadth of views here. I hope, though, that we will hear on this Committee from representatives of the nearly 9 million workers who lost jobs or the 5 million Americans who lost their homes to foreclosure during the Great Recession or the millions of taxpayers that provided billions of dollars in bailout funds. I know this Committee has heard me say this, but my wife and I live in ZIP Code 44105 in Cleveland. In the first half of 2007, that ZIP Code had more foreclosures than any ZIP Code in the United States of America. We should be listening to people who really paid the worse kind of price for what happened less than a decade ago.

Congress put in place a framework for capital and liquidity rules, including stress tests and living wills, to strengthen the U.S. banking system. We did this to prevent a repeat of the economic devastation that forever changed the lives of millions of our fellow Americans.

The rules were meant to tighten as institutions increase their size and complexity and riskiness, and the agencies have tailored their rules to banks of varying profiles.

Last week, the Chair of FDIC, Martin Gruenberg, observed that, at the end of 2015, large banks, the largest banks, had twice as much Tier 1 capital and liquid assets in proportion to their assets as they had entering the crisis—a development we all should welcome.

He concluded the evidence suggests that the reforms put in place since the crisis have been largely consistent with, and supportive of, the ability of banks to serve the U.S. economy.

Mr. Chairman, without objection, I would like to submit Chair Gruenberg's full remarks for the record of today's hearing. Mr. Chairman, without objection? Thank you.

Chairman SHELBY. Thank you.

Senator BROWN. In addition to instituting much needed reforms to bank capital, to liquidity, to risk management, and other standards, Wall Street reform tailored its approach to the regulation of community banks.

For instance, it carved about 98.4 percent of banks out of direct CFPB supervision and limitations on so-called swipe fees. Apparently, that is all but four members of the Independent Community Bankers of America at the time that Dodd-Frank became law. All but four of its members.

Even more banks were exempted from the changes in the treatment of trust-preferred securities under the new capital rules. Perhaps most importantly, small banks benefited from a change in the FDIC's assessment formula included in Dodd-Frank.

When the change was implemented in the second quarter of 2011, small banks' assessments fell by one-third, saving these banks over $1 billion. Last year, FDIC announced additional changes that will further lower the assessment rates for 93 percent of small banks.

Just this past Tuesday, sitting at that table, Federal Reserve Chair Janet Yellen indicated that the Fed, the FDIC, and the OCC may tailor their rules further, as they use an interagency regulatory review process to consider what she said, "a significant simplification of the capital regime for . . . community banks." Again, something that a number of people in this room, I think, would welcome.

Regulators have tailored rules to provide relief to larger banks when appropriate, as both sides of the aisle have asked of them. The Fed recently announced plans to alter stress test requirements for banks over $50 billion in total assets.

Despite this reality, many of my colleagues on the other side of the aisle have called for dismantling Dodd-Frank—again and again and again.

The Chair of the House Financial Services Committee is pushing for Wall Street reform to be, as he said, in a quote reminiscent of perhaps 100-plus years ago, "ripped out by its roots and tossed on the trash heap of history."

Some have even claimed, despite the solid evidence to the contrary, that Wall Street regulations are the cause of, not the cure for, financial instability.

The inconvenient truth is that a financial crisis, brought about by reckless deregulation and Wall Street greed—no question about that—set off a broader economic crisis that helped to contribute to my ZIP Code leading the Nation in foreclosures.

The recovery from that crisis has required a sustained period of record low interest rates that have compressed banks' profit margins. But that does not make for a compelling hearing topic for an agenda that views repealing Dodd-Frank, or many of its reforms, as the panacea for all economic issues, real and imagined.

The President of the ICBA, Cam Fine, said it well last October:

> Dodd-Frank . . . became the poster child for every regulatory ill that has been foisted onto community banks . . . There are regulatory burdens that community banks face today that are real, but had nothing to do with Dodd-Frank.

I look forward to a time when we can stop fighting old partisan battles. The families living in the low- and moderate-income communities that are still struggling to recover deserve more of our attention and our energy.

Thank you, Mr. Chairman.

Chairman SHELBY. This morning, we will receive testimony first from Ms. Rebeca Romero Rainey, who is the Chairman and Chief Executive of course, of Centinel Bank of Taos. She is also the Chairman of the Independent Community Bankers of America.

Next we will hear from someone who is no stranger to this Committee, the Honorable Wayne Abernathy, who is the Executive Vice President for Financial Institutions Policy and Regulatory Affairs at the American Bankers Association.

Then we will hear from the Honorable Greg Baer, who is the President of The Clearing House Association and Executive Vice President and General Counsel at The Clearing House Payments Company.

Finally, we will receive testimony from Ms. Jennifer Taub, who is Professor of Law at the Vermont Law School.

We will start with you, Ms. Rainey. All of your written testimony will be made part of the hearing record, but you proceed as you wish.

STATEMENT OF REBECA ROMERO RAINEY, CHAIRMAN AND CEO, CENTINEL BANK OF TAOS, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

Ms. RAINEY. Chairman Shelby, Ranking Member Brown, and Members of the Committee, my name is Rebeca Romero Rainey, and I am Chairman and CEO of Centinel Bank of Taos, a $215 million asset bank headquartered in Taos, New Mexico. I am a third-generation community banker. Centinel Bank was founded by my grandfather, Eliu Romero, in 1969. Years earlier, he had been denied a loan to finance his startup law practice. That experience led him to start a bank that would provide credit for all people within our community, and I am proud to carry on his legacy.

I am also Chairman of the Independent Community Bankers of America, and I testify today on behalf of the more than 6,000 community banks we represent. Thank you for convening this hearing. Bank capital regulation has the power to promote or to stifle community bank lending.

We believe that changes are urgently needed. In particular, ICBA urges this Committee's support for an exemption from Basel III capital rule and a return to Basel I for banks with assets of less than $50 billion.

Under Basel III, community bank capital regulation became significantly more punitive and complex. Do we really need four definitions of regulatory capital, a capital conservation buffer, and impossibly complex rules governing capital deductions and adjustments?

At its inception, Basel III was meant to apply only to the largest international banks. Applying the rule to community banks in a one-size-fits-all manner harms the consumers and businesses we serve.

Aspects of Basel III that are of particular concern include: High volatility commercial real estate, or HVCRE; complex new reporting requirements; the capital conservation buffer; and the punitive treatment of mortgage servicing assets and investments in trust preferred securities, or TruPS.

Basel III's overly broad definition of HVCRE sweeps in too many development projects. Taos needs new development—hotels, apartments, buildings, shopping centers—to create jobs and finally lift us out of the last recession. Basel III risk rates HVCRE lending at 150 percent, 50 percent higher than under Basel I.

We want to make every creditworthy loan we possibly can, consistent with reasonable capital requirements and safety and soundness. But the HVCRE risk rates will force us to make difficult tradeoffs in lending to promising development projects.

Another troubling aspect of Basel III is the contribution to the page count and complexity of our quarterly call report, which had already become a nearly unmanageable burden. Centinel Bank's last call report was 93 pages long, and it took 2 ½ weeks of employee time to prepare it. For this reason, highly rated community banks should be allowed to submit a short-form call report in the first and third quarters of each year. ICBA thanks Senators Moran and Tester for introducing S. 927, which would provide for short-form call reports.

The capital conservation buffer poses a special challenge for more than 2,000 community banks organized under Subchapter S of the Tax Code, including Centinel Bank. As a passthrough entity, we are taxed at the shareholder level. If the capital conservation buffer were to prevent us from making distributions, our shareholders would be forced to pay its tax on their share of the bank's undistributed net income out of their own pocket—a prospect that makes it harder for us to seek new shareholders. Basel III raises capital levels, but it also makes it harder to meet them.

The punitive capital treatment of mortgage servicing assets is driving communities banks out of the servicing business and promoting consolidation or, worse, the sale of servicing assets to nonbanks, which are not subject to prudential standards. Community bank investments in TruPS are being punished by similar capital treatment, with a direct impact on their lending capacity. For all these reasons, exemption from Basel III is a priority for community banks. I seriously doubt that my grandfather would have founded Centinel if we had to comply with Basel III and other new regulations that exist today.

We are grateful to Senator Rounds for introducing S. 1816, which would exempt banks with assets of less than $50 billion from Basel III. In addition, I encourage this Committee to consider measures that would help us meet our higher capital requirements under the new rule.

A bill recently passed the House, H.R. 3791, which would raise the asset threshold for the Federal Reserve's small bank-holding company policy statement from $1 billion to $5 billion. This change would provide capital relief to some 415 additional bank-holding companies.

I would like to thank this Committee for raising the threshold from $500 million to $1 billion. ICBA has long held the position that the threshold should be significantly higher to recognize the higher-average asset size of today's community bank and thrift-holding companies.

With that, I will conclude my statement, and thank you again for the opportunity to testify. I am happy to take your questions.

Chairman SHELBY. Thank you, ma'am.
Mr. Abernathy.

STATEMENT OF WAYNE A. ABERNATHY, EXECUTIVE VICE PRESIDENT, FINANCIAL INSTITUTIONS POLICY AND REGULATORY AFFAIRS, AMERICAN BANKERS ASSOCIATION

Mr. ABERNATHY. Thank you, Chairman Shelby, Senator Brown, and Members of the Committee. The American Bankers Association represents the breadth and depth of the banking industry from the smallest to the largest and all business models.

Our chief recommendation is that regulators, regulated, and the public begin an inquiry into what works. We appreciate the Fed starting with stress testing. We are in the eighth year of an intensive regulatory reform process. The whole is overwhelming for each individual bank, but also a ponderous weight upon regulators.

Increasing regulatory capital is contractionary. Financing banks by deposits is expansionary, funding economic activity. We need more of the latter.

Excessive capital rules mean more capital but no additional financial service. The largest banks must monitor more than a dozen capital dials. Does each have equal supervisory value? If not, do those with lesser value steal attention?

Academic debate pits risk-based capital against leverage capital. Bankers and regulators use both. The leverage ratio is a risk-blind model, all assets given equal weight.

Whatever might be said about errors in risk-based, we can be certain that the Procrustean simplicity of the leverage ratio is always wrong. The 1980s S&L experience demonstrates that risk-blind simplicity hides the riskiness of assets until they explode, an approach rejected by all regulators and by the law.

Liquidity is dynamic. Financial instruments are liquid until they are not. Fannie Mae and Freddie Mac securities once seemed so liquid that thought was given to using them for monetary policy. The Basel-prescribed liquidity schemes ignore liquidity's dynamic nature. They are static, sure to become out of date. Like Dorian Gray, they rely on an unchanging picture of liquidity while reality changes all around.

They do not fit U.S. realities. Under the Basel liquidity coverage ratio, LCR, banks must assume that financial stress will cause a run on deposits. Our banking industry saw an influx of deposits by $813 billion during the recession.

The current structure of the LCR will hasten and deepen recession. Banks must concentrate holdings in a narrow list of high-quality liquid assets, HQLA, short-term Government securities. If there is not enough, what will happen? Panic. HQLA will become only one-way liquid. Who will be willing to let go of their supply? Those without enough will have trouble finding more.

Basel's other liquidity rule, the net stable funding ratio, NSFR, now under comment, lacks a purpose. There is no problem that the NSFR would solve that is not already addressed.

ABA offers the following recommendations:

In 2014, ABA and bankers associations from every State and Puerto Rico asked regulators to recognize that highly capitalized

banks already meet Basel III standards, without the complex calculations.

Basel III came before the public, Congress, and industry far too late. We are still working through Basel problems that could have been avoided, including the dangerously narrow HQLA, the punitive treatment of mortgage servicing assets, Subchapter S banks, and investments in TruPS. Prior to foreign negotiations, agencies should involve the public, Congress, and industry through publication of an Advance Notice of Proposed Rulemaking. This should apply to financial standards whether banking, insurance, asset management, or other financial products and services. The NSFR should be withdrawn.

Basel III should grandfather existing TruPS. Under Basel, any amount of TruPS above 10 percent of bank equity is treated as a loss, regardless of performance. Many hometown banks are seeing their capital requirements skyrocket.

Rules are more complex than they need to be, too complex for regulators and regulated alike. The American banking industry is eager to engage in the conversation we recommend. Supervision and management can be even more effective. That will be better for regulators and the regulated, and especially for the people whom we all serve.

Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Baer.

STATEMENT OF GREG BAER, PRESIDENT, THE CLEARING HOUSE ASSOCIATION, AND GENERAL COUNSEL, THE CLEARING HOUSE PAYMENTS COMPANY

Mr. BAER. Chairman Shelby, Ranking Member Brown, Members of the Committee, my name is Greg Baer, and I am President of The Clearing House Association. We are a nonpartisan organization that contributes research, analysis, and data to the public policy debate. We are owned, along with our sister Payments Company, by 24 of the largest banks operating in this country.

Today I will first describe how core post-crisis reforms have made banks more resilient and more resolvable.

Second, I will describe other reforms, many still pending, whose costs appear to greatly exceed their marginal benefit.

Last, I will provide an overview of some of the cumulative effects of these regulations.

The first core reform is capital regulation. For our 25 owner banks, Tier 1 common equity has nearly tripled over the last 7 years, to over $950 billion.

As a useful benchmark for just how much capital that is, consider the Federal Reserve's CCAR test. Large banks must now be able to weather an extraordinary stress, everything from an unprecedented 4-percentage-point increase in unemployment over four quarters to an 11,000-point loss in the Dow, all while continuing to do business as usual.

A second core reform is liquidity regulation. Under the liquidity coverage ratio and other rules, large banks are substantially less likely to fall victim to a run now. The FSOC recently reported that the largest banks now hold about 30 percent of their balance sheet

in the form of Treasurys, cash, and other highly liquid assets, nearly double pre-crisis levels.

A third core reform is resolvability. As detailed in my testimony, Title I and Title II of the Dodd-Frank Act are core reforms that ensure that any bank can be resolved in a way that requires no taxpayer assistance and does not destabilize the broader system. And markets understand this change as they are pricing bank debt assuming they are fully at risk.

The Clearing House strongly supports these reforms. However, 8 years past the crisis, regulations are still being written that have high costs and minimal benefits. These include:

First, the U.S.-only supplemental leverage ratio. Under this rule, our banks are holding over $50 billion in capital against cash on reserve at the Fed, capital that could be deployed to lending. It also has sizable adverse effects on capital markets activity and custody services.

Second, the U.S. G–SIB surcharge, one of many Basel reforms where U.S. regulators have dramatically increased requirements for U.S. firms only, with significant ramifications in this case for capital markets.

Third, a newly proposed countercyclical capital buffer, which would allow the Federal Reserve to raise capital even further based on an unproven and largely unexplained macroprudential theory.

Fourth, ring fencing for foreign banks that is diminishing their ability to serve U.S. businesses.

Fifth, another liquidity rule, the net stable funding ratio, that appears likely to limit loan growth while delivering no marginal benefit.

Finally, and perhaps most significantly, a whole series of pending Basel rules, collectively known as "Basel IV," which would rewrite many of the capital rules again, with substantial impacts on nearly every aspect of the U.S. economy.

My written testimony describes these rules and others in detail, so let me focus on their cumulative impacts.

Capital and liquidity rules are shrinking credit availability, particularly to small businesses and low- to moderate-income consumers. While nonbank alternatives have sprung up, they tend to be expensive and will likely prove less available in an economic downturn. Whether with payday lenders, finance companies, or online lenders, prices charged to consumers and businesses are extremely high. This should come as no surprise because this is what banks are built to do. Not only do banks have access to lower-cost and more durable funding, they know the borrower and are better able to price the risk.

In capital markets, bank dealers are exiting businesses. Dealer inventory is shrinking, trade sizes are getting smaller, and trading is clustering in on-the-run issuance by only the largest companies, markets where liquidity is still to be found. Small and mid-size firms have less access to capital markets and, thus, are more reliant on bank lending, just as it is becoming more difficult to obtain.

Thus, when the next economic or financial crisis comes, there is reason for concern that large banks will become a systemic Maginot Line, extremely well fortified, all but certain to remain intact, but playing little useful role in battling risk. We do not know what

geopolitical shock or asset bubble will cause such a crisis, but the chances of its first victims being banks with three times the capital they held before the last crisis, with plentiful liquidity, appear very low. Rather, shadow lending and trading systems that are undiversified, market-funded, and unsupervised would seem to be a more likely source of flagration and accelerant.

In short, the current regulatory priority should not be reinforcing the Maginot Line with new rules but, rather, exploring other sources of risk outside its borders.

I hope this has been helpful, and I look forward to your questions.

Chairman SHELBY. Thank you.

Professor Taub.

STATEMENT OF JENNIFER TAUB, PROFESSOR OF LAW, VERMONT LAW SCHOOL

Ms. TAUB. Chairman Shelby, Ranking Member Brown, and distinguished Members of this Committee, thank you for this opportunity to testify today. My name is Jennifer Taub. I am a professor at Vermont Law School, and formerly I was an Associate General Counsel with Fidelity Investments. I offer my testimony today solely as an academic and not on behalf of any association.

The title of today's hearing, "Bank Capital and Liquidity Regulation," sounds terribly technical, seemingly a topic just for the experts. But it is not. Reducing excessive bank borrowing through higher capital requirements matters to us all.

Bank capital is much more than just numbers you can count up on a balance sheet. Bank capital is what we can count on to ensure a more stable financial system that serves the credit needs of American families and businesses.

So what do we mean by capital? Let us say I want to buy a small business for $100,000, and I borrow $95,000 from my cousin and pay the balance in cash. My equity capital would be $5,000, the difference between what I own and what I owe. That is a 5-percent leverage ratio.

If my cousin suddenly demanded the money back, hopefully I could sell the business for at least $95,000. If not, I have wiped out my capital and would be scrambling for other things to sell to fully pay back that loan. That is the downside of leverage. But if I can sell the business for $105,000, I have doubled my money, the upside of leverage.

Extending this metaphor, liquidity is about whether I have enough cash on hand to fully pay back the loan while I wait a bit to try to fetch a better price for that business.

Similarly, banks borrow money from their depositors and other lenders. They use this funding to make loans and to buy other assets like derivatives. If their depositors or other lenders demand their money back and assets cannot be sold at full value, the bank's capital cushion is supposed to absorb the difference. If it is too thin, then we, the people, may have to bail them out.

When banks borrow excessively, in good times they gain. In bad times we all lose. If banks teeter and topple, lending tightens, and the broader economy suffers. We see job losses, investment losses,

home losses. This is a hard lesson that we have learned and forgotten time and time again.

If we take financial historians seriously, we would understand that this time is not and will not ever be different. Financial crises share common elements. After an asset bubble deflates, thinly capitalized banks that hold deflating assets collapse when depositors or other lenders withdraw their money. Even good assets cannot be sold at full price under stress. This spreads. Government rescues follow when leaders realize the collapse of a giant bank could cause cascading failures and wider damage.

We were schooled in this too-big-to-fail problem in 2008. Let us recall that the U.S. Government committed many trillions of dollars in direct and indirect bailouts to rescue the system. Some will assure you this does not matter anymore because most of the money was paid back. That is cold comfort for the more than 6 million families who lost their homes to foreclosure since 2008 and to all of us who are struggling in an economy that is just beginning to pick up steam.

To help ensure that this would never happen again, Dodd-Frank was enacted. This law provides regulators with tools to rein in excessive borrowing and otherwise help end too-big-to-fail. The related rules have made the system safer but not safe enough. The current 4-percent leverage ratio is way too low. The soon to be required 5 percent for our largest bank-holding companies and 6 percent for their insured depositories will still be too low.

So how much capital is enough? Financial economists Anat Admati and Martin Hellwig recommend at least 20 percent. Together with other leading economists, they have advocated for at least 15 percent. This would confer substantial social benefits with few social costs.

This measure should be based on total, nonrisk-weighted assets, including certain off-balance-sheet items. While the risk-weighted asset approach complements the leverage ratio, it is not enough on its own. It is subject to arbitrage and abuse.

Let us be clear, though. A healthy equity capital cushion is necessary but not sufficient. Allowing banks with a mere 10-percent leverage ratio a free pass from other crisis prevention and intervention rules is misguided. This is but one of the many faults with Chairman Hensarling's bill.

In conclusion, more bank equity capital and better bank liquidity means less systemic risk and reduces the cost of crises. It makes banks less fragile and more capable of lending even after suffering losses.

Thank you for the opportunity to speak. I look forward to your questions.

Chairman SHELBY. Thank you.

Ms. Rainey, I will start with you. In your testimony, you state, and I will quote, "Applying Basel III to community banks in a one-size-fits-all manner harms the consumers and businesses that rely on community bank credit." Those are your words. In particular, you mention that the additional capital required for high volatility commercial real estate will, and I will quote you again, "force [you] to make difficult tradeoffs in lending to promising development projects" that will reduce credit and harm job creation.

How will this impact your ability to do business in your community going forward? Give us an example.

Ms. RAINEY. An example is the HVCRE capital requirements. So as I look at development projects, which I am anxiously awaiting coming back to our communities—you see, in Taos, New Mexico, we are dependent on tourism. That is what drives our market. We are still deep within the throes of a recession. And as those projects come into our community, be it hotels, restaurants, things that will help provide jobs, resources for our community, the additional risk weighting of those loans makes it very difficult for us as a smaller organization to make that difficult decision to take on that development project. And in our small community, there are very few options for financing.

Chairman SHELBY. And your bank is a small bank. You said is $215 million.

Ms. RAINEY. Yes, sir. We are $215 million.

Chairman SHELBY. OK. Mr. Abernathy, in your testimony you state that the application of global standards to the entire U.S. banking industry can have a disproportionate and unexpected impact on community banks. One example you provide is how the Basel III treatment of trust preferred securities is causing hometown banks', small banks' capital requirements to skyrocket. Explain for the Committee how the Basel III treatment of trust preferred securities is negatively impacting community banks, and what is the end game here?

Mr. ABERNATHY. Thank you, Mr. Chairman. It is a good example, this particular case, of how these global rules, when you take them and bring them to a particular nation and apply them, do not always fit. And Basel is a real good example, that and TruPS is one of the ones I like to point to.

Under the Basel III rules applied to TruPS, the intent of Congress, which was to grandfather or hold TruPS investments harmless, is undermined because under the Basel III capital rules, they would apply a capital charge to anything above 10 percent of equity in the investments in TruPS. And what they require the bank to do is to treat that as if it were a loss with no recognition as to how that asset is actually performing. That is one of the kind of fixed and Procrustean rules that you get from Basel that just does not work with our economy.

Chairman SHELBY. How can we work through that, yet make sure that the smaller banks have adequate capital? And we want good capital, we want strong banks, whether they are large or small, right?

Mr. ABERNATHY. Yes, absolutely. One of the things that is very positive about Basel is that it is requiring that the quality of capital be improved. That is a principle that should apply to every bank. But where the problems arise is when you are looking at the very complicated risk-weighting calculations that you have to apply to all of your assets.

What we have proposed in our testimony, which all of the State bankers associations and ABA has proposed to the regulators, is that if a bank has, say, twice what Basel could ask for in capital, that should be enough of an indication to the regulators that that

bank is already complying with Basel and should not have to go through all the detailed calculations to get there.

What you find is a bank, I am sure, like my colleagues here and, frankly, thousands of banks around the country, they are sitting on this much capital, they have got to go through the Basel calculation, and it says you need only this much, and they say, "What was that all about? Why did we have to go through that calculation when in the end you just demonstrate that we have twice what we need?"

They should not have to go through that because it serves no beneficial purpose, for regulatory purposes or for the bank.

Chairman SHELBY. But you would agree with me that capital is very important to the small banks, medium banks, large banks, and so forth. But I would think—and you can correct this if I am wrong—that capital for a lot of the community banks is harder to raise than it would be for some of the money center banks.

Mr. ABERNATHY. That is true. Community banks have fewer sources or accesses to capital. That is why the TruPS instrument was invented back about 10, 15 years ago. What was demonstrated is that it does not absorb losses as well as we would like, so that was taken off of the table. But it was grandfathered so that you are not imposing a new loss and cost upon community banks as they adjust. But it is true that community banks have fewer sources of capital that they can go to.

Chairman SHELBY. Mr. Baer, in your testimony you state, and I will quote, "As regulatory requirements—and, in particular, capital and liquidity requirements—become increasingly stringent and granular, they . . . effectively drive capital allocations." Provide a few examples of how regulatory requirements are driving capital allocation and explain any concerns you may have with this approach. And what does it do to the business community, small business and medium size?

Mr. BAER. Thank you, Mr. Chairman. There are innumerable examples. Let me just try to give you a couple.

One, for example, if you look at the Fed CCAR stress test, which is now really the binding constraint for almost all large banks, if not all large banks, it contains a FICO cutoff of 620; that is, although we do not know exactly how the models work, certainly those above 620 are treated far better than those below 620. So that will necessarily drive bank lending decisions, and you will be much better off at 630 than, say, 610.

It also does not distinguish between, say, a 620 that has been rising for years from the 500s to someone who had a 700 a few weeks ago and is now obviously experiencing a credit crisis. So in that way, it is displacing bank judgments about what are really fine decisions that need to be made.

I think Ms. Rainey gave another example with respect to community banks. They are everywhere. Also within CCAR, there is a particularly tough treatment of BBB spreads which will affect activity in lending markets. There are examples where under CCAR the assumption around unemployment is extremely severe, which necessarily puts pressure on loans that are subject to greater default rates if, in fact, unemployment rises, which are basically

loans to folks who do not have significant wealth or a steady income.

Chairman SHELBY. Mr. Abernathy, my last question. Earlier this week here, Chair Yellen of the Board of Governors of the Fed appeared before this Committee, and I asked her whether the current effort to review CCAR will result in more meaningful tailoring in a way that recognizes the different risk profiles of banks. She responded that it was "very likely" that regional banks would receive an exemption from a part of the stress test.

How can the Fed revise CCAR to appropriately address the different risk profiles of banks? Can they do that? I mean, banks do have different profiles.

Mr. ABERNATHY. They do, absolutely, Mr. Chairman, and that is one of the things that we are really very encouraged about by Chair Yellen's testimony, that it appears that the Fed is engaging in exactly what we are calling for in our testimony, a conversation with Congress, with the public, with the industry, to look at these different regulatory tools that have been put in place and asking, How can we make them better? Tailoring the CCAR and the other stress tests is an important way of doing that and recognizing that there are a variety of different business models.

If you want your stress test to genuinely stress and test particular banks, you need to model it based upon the business plan of that particular institution. And it is not just size. It is the whole risk portfolio of the particular institution. They have authority to do that. We hope they will do that. We hope they will do that in conversation with the public, Congress, and with industry. I think that will increase the likelihood that we will get it right.

Chairman SHELBY. Thank you.

Senator Brown.

Senator BROWN. Thank you, Mr. Chair.

Professor Taub, thank you for your clear, understandable way of discussing and explaining leverage and risk and liquidity and capital. In 2009, when then-Secretary of the Treasury Geithner was presenting the framework for Wall Street reform to the House Financial Services Committee, our counterpart, he said:

> You want capital requirements to be designed so that, given how uncertain we are about the future of the world, given how much ignorance we fundamentally have about some elements of risk, there is a much greater cushion to absorb loss and to save us from the consequences of mistaken judgment and uncertainty in the world.

We now are 8 years beyond the crisis. There seems to be a sense of amnesia setting in, certainly to this Committee, to the Senate, and to many in the public. Give me your observations on how the arguments around capital have evolved from the time of Secretary Geithner's observations.

Ms. TAUB. Senator Brown, thank you for your question. I really think that is an elegant statement by Secretary of the Treasury Geithner about the importance of equity capital as a buffer.

I do think there has been a kind of selective amnesia that has set in. I think memories are good that Washington will be here to bail out the banks in the future, and that is why I believe there is this extensive lending and forgetting about the need to raise equity capital requirements.

If you look back in 2010, we had many folks saying, including Alan Greenspan, that the banking system had been undercapitalized for years. We have had folks, including Nobel Laureate Eugene Fama, suggesting dramatically needing increases in capital, perhaps up from where we are to 40 to 50 percent. Alan Greenspan, in 2013, when he was making a book tour, mentioned that perhaps 22 percent capital would be necessary. But here we are with just 4 percent waiting for the 5- and 6-percent leverage capital ratios to kick in.

So I think it is a shame that we have not—when there is so much bipartisan support on the need for capital buffers, that we are still at these low levels at this point.

Senator BROWN. Thank you, Professor Taub.

This is for all the panelists, and I will start with you, Ms. Romero Rainey. Did risk posed by systemic nonbanks play an important role in the crisis? And do you find that heightened regulation of nonbanks is important, both to protect our financial system and to help regulated banks remain competitive? So really two questions for each of you, if you would answer it fairly quickly. Would nonbanks play a role, systemic role in this? And, second, heightened regulation of nonbanks, is that important?

Ms. RAINEY. Yeah, I think all entities should be regulated for the risks that they pose to the system.

Senator BROWN. OK.

Mr. ABERNATHY. Thank you for that question because it goes right to the other thing you did earlier, which is put FDIC Chairman Gruenberg's recent speech in the record. In that speech—and I was there and heard him deliver it—he pointed out that the banking industry today makes up only 16 percent of the financial services industry. That is the market share of the banking industry. Where is the other 84 percent? That is in the nonbank world. Can we ignore that and assume that we have covered all the risks? The answer is no. We have to look at the entire package. Whereas, a lot of the regulatory effort in recent days has been on the 16 percent, which I think is important, but let us not ignore the rest.

Senator BROWN. Mr. Baer.

Mr. BAER. I think it is good to remember that AIG, Lehman Brothers, Bear Stearns, Countrywide were not banks. No one really had thought about the potential systemic impacts of a money fund, the reserve fund going bust. So I think it is actually quite important, particularly now, to recall how much of the financial crisis originated outside and spread through the nonbanking system. It gets back to the Maginot Line point I was making earlier, which is as we push more and more risk out of the banking system, it is a very good time to ask: Where is that risk going? How do we feel about that? And how is it being regulated?

Senator BROWN. Ms. Taub.

Ms. TAUB. So our concerns about nonbanks or the shadow banking system are not new. In 2010, the Federal Reserve Bank of New York noted that $16 trillion in liabilities were with the shadow banking sector versus $13 trillion with the traditional banking sector. And I would also point out that I consider Countrywide to be a bank, as it was a thrift-holding company.

But I think some of this attention to nonbanks is a bit pretextual. I was just at a hearing at a House Subcommittee a few weeks ago, and folks were lobbying for reducing the amount of oversight on nonbanks such as private equity funds and hedge funds. So I wish we would get our stories together here.

Senator BROWN. Let me follow up with you, Professor Taub. We hear the argument a lot that bank regulations will force more financial activities to the nonbank sector, the less regulated sector. One, tell us whether that is actually happening. And, second, what is the best way to prevent that kind of migration—to regulate banks less or to regulate other activities—to regulate all activities equally?

Ms. TAUB. So in referring to Gruenberg's speech that we have been talking about, he noted—and he has—I think the third exhibit is a chart showing that the amount of loans in the nonbank financial system have been steady, not increasing, relative to before. So that is one thing. But I think where we can all agree is that if there is a problem in the shadow banking system, let us take a look at that. For example, why not look at reducing leverage at hedge funds and so on? I am all for that.

Senator BROWN. Thank you.

Mr. Baer, just a yes or no, if you could, to this. Chairman Hensarling proposed repealing Title II of Dodd-Frank, as you know, which provides for an orderly liquidation authority for large financial institutions, and Title VIII, which provides for heightened regulation of systemically important clearinghouses. Would you support repealing either of those?

Mr. BAER. I will try to do it in more than one word, unfortunately, but we support Title II as a credible backstop to Title I. We do believe that bankruptcy should always be the first option in resolving a large bank. But it seems sensible to have a fallback plan in the form of Title II.

Then with respect to Title VIII—and I have to say this a little grudgingly because The Clearing House Payments Company is actually a designated financial market utility under Title VIII, so talking against interest here. But we do believe it is appropriate to designate financial market utilities and have supervision of them.

Of course, that should not be the same type of supervision as you would get with a bank. It should be tailored to the activities and risks of the CCP or whatever the FMU is. Sorry for the acronyms. But, yes, we support that.

Senator BROWN. Thank you.

Last question, Professor Taub. Should we be concerned by proposals that use capital requirements as a sort of Trojan horse for broad-based deregulation of the industry?

Ms. TAUB. Whenever someone says "Trojan horse," I think we should be cautious, yes. I mean, I do think that, as Hensarling's bill is trying to do, is to say if there is a 10-percent leverage ratio, that should be enough to get out of so many of the Dodd-Frank regulations, that is a mistake. As we just heard from Mr. Baer, Title II is a really important backstop in case—and as you mentioned before, it is very hard to predict the future. And so we do need to have this possibility in the alternative of a bankruptcy if that

cannot happen in an orderly fashion to have Title II, for example, good supervision is also critical. So I do not think that this is, you know, a free pass out of sensible prudential regulation.

Senator BROWN. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Scott.

Senator SCOTT. Thank you, Mr. Chairman.

Ms. Rainey, Chair Yellen appeared before our Committee just a couple of days ago and stated in the past that, when it comes to bank regulation and supervision, one size does not fit all. Other Governors at the Federal Reserve have also echoed those comments. Community banks have reported major increases in their compliance burden since implementation of Dodd-Frank. In February of this year, the Fed, FDIC, and the OCC increased the number of banks and savings associations eligible for the 18-month examination cycle as opposed to the 12-month cycle. Well-capitalized and well-managed banks and savings associations with less than $1 billion in total assets may be eligible for this relief.

First, how important is the extension of the exam cycle to community banks?

And, second, from your perspective, what are some other measures that can be taken to relieve the regulatory burden on smaller institutions?

Ms. RAINEY. Thank you, Senator. Yes, as we look at the exam cycle, to give you a relevant example, I am preparing for a compliance exam right now. We just received our pre-exam checklist that is over 30 pages long; there are over 400 individual questions in my $215 million bank that we are preparing for. And this comes about each and every year as we are preparing for examination throughout compliance, IT, BSA, and safety and soundness—our four different exams that we prepare for. So to lengthen the time between exams for well-rated, highly capitalized banks I think is very important and makes a significant difference.

I would draw back to the capital rules that we are talking about here today to look at an exemption, just in terms of both what we are doing to comply with these regulations as well as the impact that it has on our lending practices could make huge strides in enhancing the environment in which community banks operate, making it—streamlining the process in which we are able to serve our customers and our communities.

Senator SCOTT. Thank you.

To both Ms. Rainey and Mr. Abernathy, the punitive treatment of mortgage servicing assets, could it have led to the third consecutive year that we have seen a drop in first-time home buyers?

Mr. ABERNATHY. I think it certainly has to affect the environment within which people take out mortgages and manage those mortgages. One of the biggest problems that we see from the Basel practice bringing global rules and applying them here is you get rules that do not seem to fit the United States, and the mortgage servicing assets is a very good example. The Europeans do not have that. But we have the relationship where the bank has a close relationship with the mortgagee and provides the services that are needed and the mortgagee knows where to go. We need to preserve that. But because of the rules under Basel, a lot of banks have had to sell their mortgage servicing to somebody else who really does

not know that business, they are learning that business, and it is notorious how poorly many of those nonbank providers are doing in servicing those mortgages.

Senator SCOTT. Thank you.

Ms. RAINEY. I agree. I think in times of stress, in good times to have a relationship lender that is servicing that mortgage, that understands the property in which that collateral is located within that community, can work with the borrower to understand the requirements, leads ultimately to better success for that mortgage, the borrower, and the institution.

Senator SCOTT. Mr. Abernathy, the LCR creates disincentives for banks to accept business deposits. Isn't this at odds with the centuries of accepted banking practices accepting deposits from customers?

Mr. ABERNATHY. Senator, one of the fundamental purposes of banking is to receive deposits—from businesses, from individuals, families, from governments. And yet the LCR, because it is a static assessment of where risk is, has decided in the terms that are there—again, a global rule applied here in the United States—that for some reason business deposits will run in times of stress. Maybe that happened in Europe, but in the United States, business deposits came in to banks. During the recession over $800 billion of deposits came in to banks because they see banks, correctly, as a safe haven. And yet banks during the next stress will have to pretend that they are going to be losing those deposits, and that makes it harder for banks to take in those business deposits when they are looking, again, for that safe haven. Where will those people go?

Senator SCOTT. Thank you, sir. My time is up.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman, and thank you, panelists, for your excellent testimony.

Professor Taub, in your comments you point out a speech by Marty Gruenberg indicating that FDIC-insured institutions have earned a new record, about $164 billion last year, and almost two-thirds of institutions reported higher earnings, which might at least raise a question of whether these regulatory difficulties not only have not inhibited profitability but in some respects might have assisted profitability. Do you have any comments on that?

Ms. TAUB. Yes, I mean, that was really impressive. We are often hearing complaints about how Dodd-Frank is hurting banks—in particular, community banks—and the economy. And yet we saw that last year the record profits were $164 billion.

In addition, what I thought was interesting about that speech is that there has been loan growth at community banks of 8.0 percent, and that exceeds the 6.9 percent compared to—that is year-over-year growth, and it exceeds 6.9 percent in terms of overall for all banks. So not only are banks overall that are FDIC-insured institutions doing better, but in particular, the community bank segment is outshining the larger banks.

Senator REED. Mr. Baer, from your position have you also tracked sort of relatively good profitability numbers in the

institutions and, also, as Professor Taub points out, loan growth, particularly in the community banks, which is critical?

Mr. BAER. I think it is fair to say——

Senator REED. Could you turn your microphone on, please?

Mr. BAER. I think it is fair to say banks, including the large banks who are members of our association, are still quite profitable. I think the interesting question for purposes of policy is: How are they making those profits? What we are seeing, if you follow bank results, is a very large focus on reducing expenses. So that has involved laying off tens, hundreds of thousands of people. The industry is also benefiting from an expense perspective from a massive move toward electronification, so fewer branches, fewer tellers, more mobile apps on your phone. In the securities business as well as, I think, in the retail business, you are seeing a great move to doing electronically what used to be done by voice or by other means. So, you know, clearly expenses are a lot of it.

And then, you know, with respect to the revenues, banks are adjusting, and the question is how you feel about how they are adjusting. So they are exiting certain business lines, and I would say measure one is principal at-risk market making, which under the capital rules, particularly the leverage ratio, has become a very expensive and difficult proposition.

They are moving into other areas. So, for example, private wealth management is a terrific business under the capital and liquidity rules. It does not require capital, it does not require liquidity, and there is not a lot of operational risk. So they have migrated, a lot of them, into private wealth management. And then the question is just how do you feel about that.

Senator REED. Just two follow-up questions. One, my impression is because of the inherent advantages of technological improvements, those cost savings would have been adopted by any sensible individual in any case. Is that your thought, too?

Mr. BAER. I agree.

Senator REED. And the other issue, too, in the migration into these more—away from market-making centers, that is more characteristic of the larger banks than community banks. Is that fair also?

Mr. BAER. Well, this really gets to—I mean, the biggest difference between the banks I represent and perhaps the ones to my right is not, I do not think, really size because the risks of making a loan are pretty much the same whether you are a large bank making a loan or a small bank. The largest banks are really the banks that are doing capital markets activity.

Senator REED. Right.

Mr. BAER. And that is why, for example, a 10-percent leverage ratio where you can debate that around an illiquid loan, the idea of holding 10 percent capital against a Treasury security becomes a lot more problematic. I think that is where we see a lot of the issues.

Senator REED. But that is more characteristic of larger institutions.

Mr. BAER. Correct.

Senator REED. And, Mr. Abernathy, thanks again. You have been a constant source of advice and counsel, and we appreciate it very much.

Mr. ABERNATHY. Thank you.

Senator REED. One of the issues that has been brought up is that there is migration to some degree—you can question how much—into the nonbank arena, which suggests that reinforcing the role of FSOC for big institutions because they can declare a nonbank institution as systemically risky, and you pointed out, I think, or someone on the panel did, let us remember, it was Lehman Brothers' failure, Bear Stearns' failure, AIG's failure that triggered a lot of the dilemmas here.

And the other issue, too, is at the commercial level, a lot of alternatives to banks fall within the purview of the Consumer Financial Protection Bureau, and its role would be even more important now if you are describing this migration away from banks. Is that fair?

Mr. ABERNATHY. Certainly where the migration is with regard to retail services, and we are seeing both with retail as well as wholesale. Frankly, it is a little bit alarming to the banking industry. When I heard the Chairman of the FDIC say the banking industry only has 16 percent of the financial market these days, representing the banking industry, I am a little bit alarmed at that because I believe there are things that banks do in terms of staying power and other things that you do not get outside of the banking industry. But there are other regulatory means of getting to these to some degree. What we notice, though, is that the rules, while they apply to nonbanks, they seem always to be enforced against banks because we have in place a means of enforcement. We have got three regulatory agencies that enforce. The nonbanks do not.

Senator REED. I appreciate that.

Finally, thank you, Ms. Rainey, for your testimony. Any comments you would like to make from the perspective of a community banker with respect to the issues I have raised about profitability, lending? Is your lending going up? Hopefully your profitability is going up.

Ms. RAINEY. Yes. Well, again, I draw back to the market dynamics, and I think as we look at the industry, so much of this depends on where the bank is located. We are still in an area that is struggling economically. So goes the community, so goes the bank, very interdependent.

You know, something I would maybe add to the comment, as I look at the industry as a whole and community banks and our future, the lack of *de novo* charters is very alarming to me in an industry where you have no birth, new creation of organizations and charters, especially in communities that desperately need those services, and I would point to many of these capital burdens. And back to our original story, you know, looking at what is required to start a bank today in a community that desperately needs it, there is unequal treatment in terms of the needs of that community and the requirements for the bank.

Senator REED. Thank you very much. Thank you all very much.

Chairman SHELBY. Senator Moran.

Senator MORAN. Chairman, thank you very much. I thank our panel for being here. While profitability is important, the ability to

continue to exist in business is related to your ability to generate a profit. I want to focus on the ability to lend, access to credit. I often tell my bankers that, yes, I am for you as a banker, I guess. But what I am really for is the community in which you serve. And I am worried that for a number of reasons, but in significant part the regulatory environment is reducing access to credit to people who traditionally would be thought of as creditworthy, capable of repaying their loan. But because of the fear of not crossing the t's and dotting the i's of regulatory burden, good loans are not being made. And I would like to know whether my sense is accurate and if there is anything that measures that. The example that I have often used in visiting with regulators is that, again, in a State like ours, community banking is a significant component of access to credit. And there are a number of bankers who have told me they no longer make a residential loan, a home loan, because of the fear of making an error or the amount of training and expertise now required to understand how to comply with the complexity of those regulations. And it just seems so—it is so troublesome to me that you would have a bank in a town of 4,000 people that has made the conscious decision we are not going to make a loan to somebody who wants to buy a home in their hometown and in our hometown, not because we do not believe that borrower can pay it back, but because we are too worried about the consequences of making an error or the expenses associated with having the personnel necessary, capably trained to make that loan. Is there something to what—are my fears founded? I guess in a broader sense is there empirical evidence about lack of access to credit related to the regulatory environment?

Mr. BAER. Senator, I mean, I think there are any number of examples of where regulation is having a measurable and clear effect in these areas. So, for example, with regard to residential mortgages, high-risk weights for prime mortgages have really taken prime mortgages off most—at least large—and I think small bank balance sheets because you just cannot earn back that capital. Jumbo loans are still there, but not prime.

Another example that I think is a good one because it shows how a very technical rule can have a very big economic effect is the liquidity coverage ratio, which I will have to say actually we at The Clearing House have a lot of sympathy for the liquidity coverage ratio and believe it is generally a good idea—the NSFR less so, but the LCR, yes. But the LCR has an outflow assumption with regard to commitments, that is, lines of credit to businesses.

The experience in the crisis was that the outflow assumptions—or the outflow experience was about 10 percent. In other words, they drew down about 10 percent. They did not look at this as crisis liquidity in the crisis. They used it for day-to-day operations. The LCR says that you have to assume 30-percent outflow, so three times what we saw in the crisis. What that has resulted in is banks of very different sizes all having to pull back on those loans or price them low.

So, similarly, custody banks are also affected by that, sort of a little off your topic, but because when they are asked by asset managers to have a line of credit to fund a redemption, because they do not want to have to hold cash to fund a redemption, again, the

custody banks are giving the same answer to an asset manager that a small- or a mid-size banker is giving to a borrower, which is under the LCR we are constrained here.

Senator MORAN. Yes, sir?

Mr. ABERNATHY. Senator, if I may, and I would echo the comments made by Mr. Baer. What we hear from our community bankers in Kansas and other parts of the country, if you ask them where is the growth in your employment, they will say, well, we are hiring more people to do compliance. How much do those compliance people interact with real customers? Well, not at all. And so you have seen more and more bank resources being applied to people who in essence work for the regulators, do not work for the customers.

Why is that important with regard to lending? A number of borrowers will come to the bank, but really what gets the economy going is when the banker goes to the customer and says, "Charlie, your business is doing really well. Have you thought about opening up an office across town?" He says, "Well, I do not know. How would I do that?" "Well, let us talk about how we could finance that."

There are fewer people available to do that, and a lot of these rules make it harder for that banker to have that conversation because now he has got to be scratching his head, and wondering, if I do that loan to Charlie, how is that going to affect my risk-based capital rules and how am I going to particularly balance all of those sorts of other regulatory requirements. It makes it much more complex and I think more difficult.

Ms. RAINEY. Specifically, coming from a rural community where no two properties are exactly alike, it has become very difficult for us. We will portfolio most of the mortgages that we make because we simply do not have secondary market options. They do not fulfill the appraisal requirements. We found out from our secondary market provider they will no longer accept manufactured homes. So, yes, we are seeing a lack of availability.

I am proud to say that in our community bank we continue to make residential mortgages because we are the source for mortgages in our community. We will roll up our sleeves, and we will get the job done. That job, though, has become incredibly complex and punitive for the smallest error that is made not because we are trying to take advantage of a customer, it is a simple human error; but the results and the impact to the organization have become much more significant and are not proportionate for the type of errors that we are making.

So, yes, cost is significantly increased. It has become harder, and there are fewer options for rural communities to have access to credit.

Senator MORAN. Thank you for the answer to my question, and I would just add that a part of this is also the need for a growing economy. A part of this is also the need for a growing economy. In a broader sense, your ability to make loans determines whether or not GDP grows at this rate or a higher rate. And our country desperately needs more opportunity for more people, and access to credit is a significant component of whether we are going to achieve that desired goal.

Mr. Chairman, thank you very much.

Chairman SHELBY. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman, and thank you all for being here today.

Earlier this month, Congressman Hensarling, the Republican Chairman of the House Financial Services Committee, provided a summary of a new bill that would repeal many of the financial reforms that Congress put in place after the 2008 crisis. In a hearing 2 weeks ago, I said that when it was introduced, the bill should be called "the Wet Kiss for Wall Street Act." Now that we have seen more details about the bill, I realize that I was wrong. It should be called "the Big Wet Kiss for Wall Street Act."

At the earlier hearing, I focused on some of the provisions in this proposal that would increase the chances of another taxpayer bailout, provisions that would make it harder to identify systemic risks and move quickly to address them.

Today, though, I want to focus on the bill's assault on the Consumer Financial Protection Bureau. According to the latest detailed summary of this bill, it will go after the fundamental structure of the CFPB, cut back on its authority to protect consumers, and weaken or repeal rules that the CFPB has already proposed. One provision would replace the current single-director model of the CFPB with a five-member commission like the five-member SEC.

Now, Professor Taub, you are a close observer of both the CFPB and the SEC. What do you think would happen to the CFPB if it adopted the SEC's leadership structure?

Ms. TAUB. Senator Warren, I think if the CFPB went from a single-director model to a five-member commission model, it would be substantially weakened and slowed down, and that I think is the whole point of Hensarling's proposal. In *HousingWire,* in June, I just read a report from a research group called Compass Point, and they predicted that if this were to happen, if it moved to the five-member commission, this already elongated rulemaking timeline would be extended, probably doubled, and that also enforcement would go down by 75 percent.

Senator WARREN. Wow. OK. So gum up the works, reduce enforcement here. You know, by the way, Chairman Hensarling has gone out of his way to claim that his bill does not have the support of Wall Street and the big banks. But I would point out that the American Bankers Association, which represents the big banks, has made it a priority for years to weaken the CFPB by making exactly the change that Congressman Hensarling proposes. I really do wonder who Congressman Hensarling thinks he is fooling here.

Another provision in the bill would revoke the authority in Dodd-Frank that allows the CFPB to restrict the use of forced arbitration clauses in credit card and checking accounts. Professor Taub, as you know, Congress directed the consumer agency to conduct a study about the impact of forced arbitration clauses, and the agency did exactly that. It did a 3-year study, and it found that those clauses are extremely harmful to consumers who have been cheated by banks.

Now, under the explicit authority from Congress as part of Dodd-Frank, the CFPB has issued a proposed rule to restrict the use of

these clauses. How do you think consumers would be affected if this rule is eliminated, as Congressman Hensarling wants?

Ms. TAUB. I think that they would be deeply harmed. These predispute arbitration provisions, or what you are calling "forced arbitration provisions," deprive consumers of their legal rights under Federal and State law. And as it happens, I did sign on to a comment letter with about 200 other law professors and scholars in support of the CFPB's rule because I think, you know, the status quo currently unfairly limits legal rights and remedies for millions of consumers.

Senator WARREN. Thank you. You know, Chairman Hensarling has tried to dress this bill up as some kind of get-tough-on-Wall-Street, pro-consumer effort. But on every front, whether it is reducing systemic risk, preventing another taxpayer bailout, protecting consumers, the bill's proposals come straight off the Wall Street wish list. These are the kinds of ideas that may attract very generous donations from Wall Street. That is what a "big wet kiss" is all about. But I know that the American people will not be fooled.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Cotton.

Senator COTTON. Thank you, Mr. Chairman. Thank you all for taking the time to testify today.

Like Senator Scott, I have some serious concerns about mortgage servicing assets, but I understand that Ms. Rainey and Mr. Abernathy addressed those fully with Senator Scott, and I just want to associate myself with his comments and with some of his concerns.

I would like to turn to a second topic, unrelated, about capital requirements and their impact on the global sanctions regime. Mr. Baer, you might be best situated to discuss this matter. Recently, Fed Governors Daniel Tarullo and Jerome Powell in separate public comments have said that the central bank would probably decide to require eight of the largest U.S. banks to maintain more equity capital to pass the central bank's annual stress tests. Do you think the Federal Reserve has fully accounted for what higher capital requirements could mean for the United States' ability to enforce sanctions through the global financial system if large U.S.-based institutions are cutting operations or withdrawing from certain markets overseas because of the costs imposed by these new actions?

Mr. BAER. Thank you, Senator. We at The Clearing House actually are quite focused on how effectual the AML OFAC regime is currently. We have seen, as you are alluding to, a large de-risking globally by U.S. and actually by U.K. and other banks as well, simply because if you do a risk-and-reward analysis, the risks of banking the wrong person under a strict liability sort of enforcement environment and where the penalties can be extremely high can really never be recouped by anything you could charge a customer like that.

There have been serious, I think, costs from that, including, you know, we have talked to folks in the development area who believe that there are countries that need banking services around the world but are having U.S. and other banks withdraw from those services. We have heard from people in diplomacy and national defense expressing concerns about the ability of the United States to

exert influence in those countries. And we have also heard from law enforcement and national security that it is a tough issue in the sense that you want to kick bad people out of the system, but you also want to observe bad people in the system. And so to the extent that U.S. banks are not doing that business abroad, that effectively blinds us to the ability to spot wrongdoing and potential terrorist financing, for example.

I think capital could play a role in that in the sense that, you know, for example, a G–SIB surcharge punishes cross-jurisdictional exposures, so one of the five factors that influence a large bank's charge is its dealings with those abroad, although that is really, I would confess, on the wholesale side, less on the retail side. Most of the largest banks are not really doing much of a U.S.—of a consumer retail business abroad. They are really managing their businesses through correspondent accounts. And so the de-risking that is taking place with the largest banks I think primarily is cutting off correspondents and large corporate borrowers. But, again, that is having a whole host of, I think, unintended consequences. And I will give credit to the Treasury Department and others who I think are actually quite focused on this issue at this point.

Senator COTTON. So you do think that Treasury and some of the other agencies or departments in the Government who might have a stake in this decision as it affects our ability to implement and enforce global sanctions are weighing in with the Federal Reserve?

Mr. BAER. I think they are weighing in. I think one of the core problems in this area, though, is sort of the incentives of those involved. For a bank regulatory agency, they are not sort of confronted day to day with concerns about development or national defense or diplomacy. I think they are, I think rightly, worried, you know, what will the reputational implications for the bank or for them be if the bank banks the wrong person.

So they have a very strong, one might say, perverse incentive to favor de-risking. That is why I think you saw this sort of unusual spectacle of the Secretary of State going over to London to lobby U.K. banks to continue banking Iranian accounts. And I think, you know, whether you think they should or they should not, the reason he was doing that was reflective of, you know, the fact that banks are quite reluctant to do anything that might eventually result in a sanction for them.

Senator COTTON. I think they are understandably reluctant, and I think "spectacle" is an appropriate word to use for these circumstances.

Would any of the other panelists care to weigh in? I know that may be a little outside your bailiwick, but we would be happy to hear from you as well.

Mr. ABERNATHY. Certainly, Senator, if I could just briefly, and certainly echo what Mr. Baer has said. One of the biggest challenges we have as a bank, one of these causes of de-risking is not only are banks required to understand their customers, but now they are being required by rules to take on responsibility for their customer's customer based upon information that they really do not have access to, and yet they get sanctioned for what a customer's customer is doing. And that is causing a number of banks to say, "I just do not make enough money in this line of business to be

able to carry that huge regulatory risk, and so I am just getting out of this business." That affects banks of all sizes, and it affects not only international but domestic banks as well.

Senator COTTON. Thank you all.

Chairman SHELBY. Senator Heitkamp.

Senator HEITKAMP. Mr. Chairman, thank you so much.

I want to talk about call reports, and most of my comments are going to really focus on the impact of all of these rules on small financial institutions. And so I want to begin by saying there is little doubt that clear and consistent capital and liquidity requirements are an essential part of a strong banking system. I think that is something we can all agree on, and it is absolutely the best line of defense against future bailouts. But small businesses and small banks, like the majority of banks in my State, have great concerns about the complex reporting requirements referenced in Ms. Rainey's testimony, and particularly because they are costly, time-consuming, and confusing, especially for smaller institutions

When you take that into account with the variety of other rules and regulations that small banks are now implementing that are unrelated to Basel, the fact that the smaller banks do not have time and resources to coordinate and implement these rules.

And so I guess I am going to ask you, Ms. Taub, what is your reaction to the small bank concerns about the increased reporting requirements? And is there a path forward, as you see it, to address what I believe is legitimate concerns?

Ms. TAUB. Thank you for the question. The way I would like to respond to it is to talk about that issue of amnesia again. I take a different lesson than Mr. Abernathy does about the savings and loan crisis. He said—and as you know, that was small and regional banks that were affected. He suggested that the lesson of that crisis was that net worth or, you know, leverage did not really hold up. But that is actually not what happened there. The savings and loans faced an interest rate shock. Then they were facing competition for deposits for money market funds. And as a result of that, they managed to achieve massive deregulation for the asset side of their balance sheet. And, in fact, it was because they were struggling in that environment that they got special accounting treatment. Instead of GAAP, it was called "RAP," and they were able to kind of monkey with their net worth.

So I would point out that it is not just large banks that can cause massive crises that result in taxpayer-funded bailouts, but also correlated bad practices at small institutions.

Senator HEITKAMP. I think it would be a little bit of an exaggeration to say the savings and loan crisis had the same consequences and result as the crisis in 2008.

Ms. Rainey, can you give us some feedback on your relationships with financial regulators, whether you believe that generally there is a level of responsiveness to a lot of the concerns that I hear from my local community bankers? And what can we do to enhance that dialogue?

Ms. RAINEY. Thank you. Yes, I feel—and I have had the opportunity to work, whether it is on advisory councils or committees, to engage in conversation, and I think those have been productive. I think as we talk about some of the specific examples here today,

whether it is call report reform or some of the pieces within the Basel rules, this exemption for community banks, so much of it also requires legislative action. And so I think in a best-case scenario, to be able to move forward in these dialogues both with the regulators as well with Congress to feel how we make some of these things happen and avail all tools possible to provide a best-case scenario.

Senator HEITKAMP. Another issue that frequently comes up is the issue of distributions from Subchapter S and taxability of those distributions or the lack of distributions but still incurring a tax liability, which can put quite a strain on a small organization, certainly on a small community family-owned bank. Can you walk me through how that requirement will be phased over the next few years, see what major risks all of that provides to community banks, and offer maybe some suggestion on how we can be more responsive to the legitimate concerns of the Subchapter S issue?

Ms. RAINEY. This is a significant and very personal issue for us. Now, while I would hope to never find myself in a situation like that, the pure fact that our shareholders, a family-owned organization, would be responsible for the earnings of the organization and to pay the amount of tax is very concerning. And I would draw your attention to an example of C corporation banks. Even if they were in a scenario below the well-capitalized limits, they would still be able to pay the taxes on the income of the organization. So why would we create a different scenario purely for Sub S organizations?

And so as we look at this, I think there is a simple solution in that we allow, even if we were in that capital conservation buffer period, the opportunity for the bank to distribute up to 40 percent of its earnings to pay the associated tax and allow for those shareholders to take care of the liability.

Senator HEITKAMP. So not avoiding the liability but making sure that the assets are there rather than personal assets to pay for profitability of the bank.

I am out of time. I will submit the rest of my questions for the record.

Chairman SHELBY. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman. Just a couple comments before the end of the hearing.

Again, thank you all for being here. It seems there are some areas of disagreement but also some areas of agreement. I thank all four of you for that. We want to ensure, especially, Ms. Romero Rainey, we want to ensure that community banks have appropriate rules. That is why in the past year and a half Congress has passed 10 provisions into law benefiting community banks. The regulators have said publicly that as part of the EGRPRA process they are considering changes to call reports, a simpler capital regime for small banks, and adjustments in the asset thresholds for real estate appraisals. The FDIC has made changes that will make it easier to start new banks, an important concern I hear from both the ABA and the community bankers.

We have taken action and there is more potential action coming on capital rules. ICBA said it well last year in support of the Fed's capital surcharge rules on the larger banks, of course, that:

> Enhanced supervision of these systemically important financial institutions together with the significant capital surcharge will provide more stability to our financial system and discourage SIFIs from becoming even larger and more interconnected.

So I think there is broad agreement we have made progress. There is also clearly the belief that our job is not yet done.

Professor Taub is right when she urges to take bold action to continue raising capital for the largest and the most complex institutions.

Thank you so much.

Chairman SHELBY. Thank you.

I want to thank all the panelists today. I think it has been a good hearing. We appreciate your input, and we appreciate your views to keep the markets going. Thank you.

The hearing is adjourned.

[Whereupon, at 11:23 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF REBECA ROMERO RAINEY

CHAIRMAN AND CEO, CENTINEL BANK OF TAOS
ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

JUNE 23, 2016

Opening

Chairman Shelby, Ranking Member Brown, and Members of the Committee, my name is Rebeca Romero Rainey, and I am Chairman and CEO of Centinel Bank of Taos, a $215 million asset bank with 48 employees headquartered in Taos, New Mexico. I'm a third generation community banker. Centinel was founded by my grandfather, Eliu E. Romero, in 1969 after he was denied a loan to finance his start-up law practice. I'm proud to carry on his legacy of service to our community by providing access to credit on an equitable basis to all responsible borrowers.

I am also Chairman of the Independent Community Bankers of America (ICBA), and I testify today on behalf of the more than 6,000 community banks we represent. Thank you for convening this hearing on bank capital and liquidity regulation. A great deal is at stake in these regulations. They have the power to promote or to stifle community bank lending, and can make or break a community. It is critically important that we get them right.

Changes are urgently needed to community bank capital regulation. In particular, ICBA urges the support of this Committee for an exemption from Basel III for banks with assets of less than $50 billion. More on that later in this statement.

At the outset, I would like to thank the Members of this Committee for your leadership in securing inclusion of community bank regulatory relief in the FAST Act, which was signed into law last December. FAST Act relief includes expansion of the exam cycle for highly rated banks, broadening of accommodations under the CFPB's "ability to repay" rule, the long-sought elimination of annual privacy notices when a bank has not changed its privacy policies, and other important provisions. We encourage this Committee to build on that record by enacting additional regulatory relief measures for community banks.

I would also like to thank the Members of this Committee who contacted the bank regulators during their consideration of the Basel III rule to express their concern about the impact of the rule on community banks. Your influence was critical to securing notable improvements in the final rule, though, as explained below, the rule continues to pose a significant threat to consumers and small businesses seeking credit.

Basel III

With the implementation of the Basel III Capital Rule, which began in 2015, bank capital regulation became significantly more complex and punitive, especially for community banks. Do we really need four definitions of regulatory capital, plus a capital conservation buffer, and complex rules governing capital deductions and adjustments? More fundamentally, why does the rule apply to community banks at all?

At its inception, Basel III was meant to apply only to the largest, interconnected, internationally active and systemically important institutions. Community banks, with their simple capital structures and conservative funding and lending practices, have nothing in common with these larger institutions.

Applying Basel III to community banks in a one-size-fits-all manner harms the consumers and businesses that rely on community bank credit. The impact will be especially harsh in small communities and rural areas not served by larger institutions. This is why 17,000 community bankers signed a petition calling for an exemption from Basel III for community banks.

Aspects of Basel III that are of particular concern for Centinel Bank and other community banks include:

High Volatility Commercial Real Estate (HVCRE)

My community of Taos has yet to fully recover from the last recession and continues to experience high unemployment. New development projects would create jobs in construction and related services, which would in turn boost consumer spending and create additional jobs. These projects might include hotels, apartment buildings, shopping centers, hospitals, or other commercial projects—important sources of employment in themselves after construction has been completed.

Unfortunately, such projects would be defined as high volatility commercial real estate (HVCRE) under Basel III—unless the borrower can contribute at origination 15 percent of the projected appraised value of the project upon its completion in cash or readily marketable assets. The borrower must also commit to tying up that

capital for the life of the project. HVCRE loans are subject to punitive risk weighting for the determination of regulatory capital: 150 percent compared to 100 percent before Basel III. I now have to allocate 50 percent more capital in order to finance a loan that my community desperately needs.

The HVCRE rule sweeps in too many creditworthy developers who are well established in our local business community, developers who exercise due diligence in planning projects with manageable risk but simply do not have the resources to tie up a 15 percent cash contribution for the life of a multi-year construction project. Such a developer might have an equity stake in land that will serve as the site of a project. But, under the HVCRE rule, any appreciated value of land equity does not count toward the required 15 percent contribution.

At Centinel Bank, we want to make every creditworthy loan that we possibly can—consistent with reasonable capital requirements and safety and soundness—to ensure the prosperity of our community and the long-term viability of the bank. The HVCRE rule will force us to make difficult tradeoffs in lending to promising development projects. The result will be reduced credit availability and higher costs for potentially job-creating projects. Rural communities will be particularly hard hit. While urban and suburban communities have access to nonbank options for project finance—lenders and investors not subject to regulatory capital requirements—communities such as mine rely almost exclusively on community bank credit. Subjecting community banks to punitive capital treatment for HVCRE lending will hobble the economic recovery in Taos, New Mexico, and in thousands of communities across the country.

ICBA is grateful to Members of Congress who have written to the heads of the banking regulatory agencies to express their concerns about the impact of the HVCRE rule.

Introduced Legislation

ICBA strongly supports the Community Bank Access to Capital Act (S. 1816), sponsored by Committee Member Senator Mike Rounds and Senator Roy Blunt, which would, among other provisions, direct the bank regulatory agencies to issue a regulation exempting community banks with assets of less than $50 billion from Basel III.

Complex New Reporting Requirements

Another troubling aspect of Basel III is its contribution to the volume and complexity of our quarterly call report—which had already become a nearly unmanageable burden. Today's call report consists of 80 pages of forms and more than 670 pages of instructions, with one new schedule alone taking up 134 pages. Centinel Bank's last call report was 93 pages long and its preparation consumed 2 ½ weeks of full-time equivalent hours. That's over a month of FTE hours each year. This is unfortunately typical of the staff burden the call report imposes on a community bank.

It hasn't always been this way. The call report is so named because it used to be called in by phone. Unfortunately, the report has grown since that time out of all proportion to its value in monitoring safety and soundness, and Basel III has only amplified it growth. As recently as 2006, before Basel III, the call report instructions were 45 pages long, roughly half of what they are now.

Only a fraction of the information collected is actually useful to regulators in monitoring safety and soundness and conducting monetary policy. The 80 pages of forms contain extremely granular data such as the quarterly change in loan balances on owner-occupied commercial real estate. Whatever negligible value there is for the regulators in obtaining this type of detail is dwarfed by the expense and the staff hours dedicated to collecting it. To put things in perspective, consider this contrast: the largest, multi-billion-dollar credit unions filed a less than 30-page call report in the first quarter of 2016. Surely, regulators can supervise community banks with significantly less paperwork burden than they currently demand.

In September 2014, nearly 15,000 community bankers representing 40 percent of all community banks nationwide signed an ICBA petition to the regulatory agencies calling for more streamlined quarterly call report filings.

ICBA's recent Community Bank Call Report Burden Survey empirically demonstrates this problem. Eighty-six percent of survey respondents said the total cost of preparing the quarterly call report has increased over the last 10 years.[1] Thirty percent said it had increased significantly. A typical $500 million asset community

[1] 2014 ICBA Community Bank Call Report Burden Survey. *http://www.icba.org/docs/default-source/icba/news-documents/press-release/2015/2014callreportsurveyresults.pdf?sfvrsn=2.*

bank spends close to 300 hours a year of senior level, highly compensated staff time on the quarterly call report.

For this reason, ICBA is calling on the agencies to allow highly rated community banks to submit a short form call report in the first and third quarters of each year. A full call report would be filed at mid-year and at year-end. The short form would contain essential data required by regulators to conduct offsite monitoring, including income, loan growth, changes in loan loss reserves, and capital position. In the recent survey noted above, community bank respondents overwhelmingly agreed that instituting a short-form call report in certain quarters would provide a great deal of regulatory relief. Seventy-two percent of respondents indicated the relief would be substantial.

Introduced Legislation

A number of bills introduced in the House and Senate would provide for short form call reports, notably the Clear Plus Act (S. 927), introduced by Senators Jerry Moran and Jon Tester.

The Capital Conservation Buffer and Subchapter S Community Banks

In addition to establishing higher minimum capital ratios and new risk weights, Basel III also establishes a capital conservation buffer of 2½ percent. Banks that do not exceed the buffer face restrictions on dividends and discretionary bonuses.

The capital conservation buffer is a concern for all banks, but it poses a special challenge for the more than 2,000 community banks—one-third of all community banks—organized under Subchapter S of the tax code, including Centinel Bank.

Subchapter S banks are "pass through" entities, taxed at the shareholder level. Shareholders are responsible for paying taxes on their pro rata of the bank's net income, whether that income is distributed or not. When a Subchapter S bank falls short of the capital conservation buffer and is restricted in full or in part from making distributions, shareholders are required to pay taxes on the bank's net income out of their own pockets. Investors expect returns on their investments, or at least deductible losses. What they do not expect is an unfunded tax bill in year when their investment had positive net income.

This possibility makes it significantly more difficult for a subchapter S bank to solicit new shareholders or to raise additional capital from existing shareholders. While FDIC and the Federal Reserve have stated that they would consider waiving dividend restrictions on a case-by-case basis, this is hardly reassuring to current or potential investors. A better solution is needed, such as a community bank exemption from Basel III, or at a minimum, a provision to allow a distribution of at least 40 percent of a Subchapter S bank's net income, regardless of the capital conservation buffer. This would ensure that a bank can distribute at least enough to cover its shareholders' taxes.

Capital Treatment of Mortgage Servicing Assets

The punitive new capital provisions of Basel III pose a real threat to community bank mortgage servicing. ICBA believes it is critical to retain and promote the role of community banks in mortgage servicing and to adopt policies that will deter further consolidation of that industry. Community banks thrive on their reputation for customer focus and local commitment. Their involvement in mortgage servicing promotes industry competition and deters future abuses and avoidable foreclosures such as those that impeded the housing recovery and led to the national mortgage settlement. Despite this, the Basel III mortgage servicing asset (MSA) provisions seem to be designed to drive community banks from the mortgage servicing business.

Basel III provides that the value of mortgage servicing assets (MSAs) that exceed 10 percent of a bank's common equity tier 1 capital must be deducted directly from its regulatory capital.[2] In addition, MSAs that are below the 10 percent threshold must be risk weighted at 250 percent once Basel III is fully phased in. Expressed in terms of capital ratios, MSAs shrink the numerator or capital (when they exceed the 10 percent threshold) and inflate the denominator or assets, resulting in a lower regulatory capital ratio. As if this were not enough, there's a third limitation on MSAs: When MSAs combined with deferred tax assets and investments in the common stock of unconsolidated financial institutions exceed 15 percent of common equity tier 1 capital, the excess must also be directly deducted from regulatory capital. Many banks that do not exceed that 10 percent MSA threshold are caught by the 15 percent combined threshold.

[2] MSAs represent the future value of servicing mortgage loans owned by third parties.

The Basel III rule is a drastic change from the previous rule which allowed a bank to hold MSAs up to 100 percent of tier 1 capital (and broader measure of capital) and risk weight MSAs at 100 percent. Any change in policy with such a broad adverse impact should have been clearly supported by data and analysis. But regulators offered no data or empirical analysis whatsoever to suggest that MSAs destabilized banks during the recent financial crisis.

Introduced Legislation

ICBA supports bills introduced in the House and Senate that would require the Federal banking agencies to study the impact of the Basel III capital treatment of mortgage servicing assets, including Chairman Shelby's Financial Regulatory Improvement Act (S. 1484).

Capital Treatment of TruPS Investments

ICBA urges this Committee to support capital relief for community banks, many of them rural-based, that invested in trust preferred securities (TruPS) issued by other community banks. Under the Basel III rule, these investments are subject to the same punitive capital treatment as MSAs: TruPS investments that exceed 10 percent of a bank's common equity tier 1 capital must be deducted directly from its regulatory capital. A capital deduction for their TruPS investments will directly reduce their capacity to provide credit in their communities.

Basel III provides an exemption for community banks that *issued* TruPS prior to May 19, 2010: These banks continue to count the proceeds of their TruPS issuances as Tier 1 capital. A comparable exemption should be provided to community banks that *invested* in TruPS. Parity between issuers and investors in the same securities will create a more equitable outcome and will provide a direct benefit to the communities they serve.

Disincentive for *De Novo* Charters

I ask you to consider the cumulative impact of the Basel III capital rule, numerous additional bank regulations that have gone into effect in recent years, and others that are in statute but have not yet been implemented. The complexity and volume of new regulation is a strong disincentive for *de novo* bank charters. I doubt that Centinel Bank or many other community banks would have been chartered if they had been faced with the daunting regulatory cost and complexity that exists today.

The FDIC has approved only two applicants for deposit insurance in the past 4 years, a dramatic shift from many years of *de novo* bank formation averaging over 170 per year. Community bank consolidation, coupled with the dearth of new charters, will leave many communities without a local bank or access to local credit. I urge this Committee to consider legislation that will incentivize much needed *de novo* bank formation.

Other Proposals That Would Support Community Bank Capital

Modernize the Federal Reserve's Small Bank Holding Company Policy Statement

Addressing the punitive capital regulation of Basel III is a priority for community banks. Short of an outright exemption for community banks, or at least targeted relief, from Basel III, I encourage this Committee to consider measures that would help us to meet our higher capital requirements under the new rule and better serve our customers and communities.

ICBA supports legislation that would raise the consolidated assets threshold for the Federal Reserve's Small Banking Holding Company Policy Statement (Policy Statement) from $1 billion to $5 billion. I would like to thank the Members of this Committee for their efforts and leadership in the adoption of legislation at the end of the 113th Congress, which raised the Policy Statement asset threshold from $500 million to $1 billion. That change has provided relief for nearly 650 bank and thrift-holding companies.

ICBA has long held the position that the threshold should be significantly higher to recognize the higher average asset size of today's community banks and bank and thrift-holding companies. Approximately 415 additional bank-holding companies would obtain capital relief if the Policy Statement were raised to $5 billion.

The Policy Statement is a set of capital guidelines with the force of law that allows qualifying holding companies to raise and carry more debt than larger holding companies and potentially downstream the proceeds to their subsidiary banks. The Policy Statement plays an important role in capital formation for smaller bank and thrift-holding companies that have limited access to equity markets. A higher

threshold will help more community banks meet their higher capital requirements under Basel III.

The Policy Statement contains safeguards to ensure that it will not unduly increase institutional risk. These include limits on outstanding debt and on off-balance sheet activities (including securitization), a ban on nonbanking activities that involve significant leverage, limitations on dividends, and a requirement that each depository institution subsidiary of a small bank-holding company remain well capitalized.

Introduced Legislation

ICBA is very pleased that H.R. 3791, which would raise the Policy Statement threshold to $5 billion, passed the House in April of this year. The bill is sponsored by Rep. Mia Love.

New Capital Options for Mutual Banks

ICBA supports the creation of a new capital option to strengthen the long-term viability of mutual banks. Mutual banks should be authorized to issue Mutual Capital Certificates that would qualify as Tier 1 common equity capital.

Mutual institutions were established and are maintained for the benefit of their communities, depositors and borrowers. They are well-run financial institutions that provide local service and investment to improve the quality of life in their local communities. In addition, mutual community banks are among the safest and soundest financial institutions. They remained strong during the financial crisis and continued to provide financial services to their customers.

Introduced Legislation

The Mutual Bank Capital Opportunity Act of 2015 (H.R. 1661), sponsored by Rep. Keith Rothfus, would authorize Mutual Capital Certificates as described above.

Closing

ICBA thanks this Committee for convening this important hearing and for the opportunity to present the views of the community banking industry.

As I stated at the outset, capital regulation has the power to make or break credit availability in thousands of rural communities and small towns across America such as Taos, New Mexico. We urge this Committee to support changes that will support vital community bank lending.

PREPARED STATEMENT OF WAYNE A. ABERNATHY

EXECUTIVE VICE PRESIDENT, FINANCIAL INSTITUTIONS POLICY AND REGULATORY AFFAIRS, AMERICAN BANKERS ASSOCIATION

JUNE 23, 2016

Chairman Shelby, Ranking Member Brown, Members of the Senate Banking Committee, thank you for this opportunity to discuss key issues of capital and liquidity in bank supervision and operations. My name is Wayne Abernathy, Executive Vice President for Financial Institutions Policy and Regulatory Affairs at the American Bankers Association (ABA). The American Bankers Association represents the breadth and depth of the banking industry, from the smallest bank to the largest bank, comprehending all of the industry's business models. Capital and liquidity are important to each of these banks.

Capital and liquidity are two of the key indicators on which bank examiners focus and rate banks as part of the supervisory CAMELS system (Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to market risk). It is hard to overestimate the significance of getting capital and liquidity management right.

This is a timely hearing. We welcome it. We recommend that financial regulators, institutions regulated, and the public served begin to take up the questions—in an orderly, considered, and comprehensive way—as to what works, what does not work as expected, and what can be improved. We envision that this can and should be done in the nonpartisan fashion that has long been the tradition of successful bank supervision in the United States. We offer our comments within that context.

As we meet today, the team of global specialists in Basel, Switzerland, are deliberating yet another dozen or more detailed financial regulatory projects, some new, some part of yet another round of adjustments to earlier Basel global regulatory prescriptions. Much like previous Basel projects, neither the American public nor the U.S. Congress have been effectively involved in these Basel deliberations. It is getting increasingly difficult to discern either what their goals are or what value the developing Basel projects have to bring to the U.S. supervisory program.

The latest Basel project for which proposed U.S. implementing regulations are currently pending for comment, is actually one of Basel's older—begun some 7 years ago: the Net Stable Funding Ratio (NSFR). The NSFR is a good example of a Basel global prescription for which it is hard to find a valid purpose in the U.S. supervisory program not already amply covered by other regulations and tools, several of which have been put in place since the Basel specialists began their work on the NSFR in 2009. I will discuss the NSFR more at length later in this statement.

We are now in the eighth year of an intensive and extensive financial regulatory reform process. Subjects have included projects affecting capital, liquidity, risk management, stress testing, failure resolution, business processes, compensation, loan-loss reserves, as well as rules and standards for specific product lines, such as mortgages and derivatives. Final regulations, guidelines, and policies have been implemented in all of these areas, with only a few pieces remaining to be applied. In this latter group are rules on Total Loss Absorbing Capacity, executive compensation, as well as counterparty credit limits. These reforms have been accomplished through tens of thousands of pages of regulations and millions of pages of bank compliance reports to their financial supervisors.

All taken together, with the experience of several years of application of the new regulatory regimes, and the publication of the full body of new standards nearing completion, we believe that this is an appropriate point for a review of how it all is working. In the press of reform, each measure has been created and implemented with less than the usual deliberation, and with imperfect reference to the other pieces. It is not credible to assume that each rule and regulation, many of which implement global schemes developed on distant shores for conditions that little prevail in the United States, is immune to improvement.

It is no criticism of the purpose of any of the reform measures to ask how each is working and to inquire into how all the pieces are working together. The whole substance is not only overwhelming for each individual bank, but we have to believe that it is an awesome weight resting upon the bank regulators who have to supervise how all of the affected banks are applying each and all of the rules. We propose for consideration that there are ways to reduce complexity for banks and supervisors that will result in improved application of the regulatory principles involved. We need to begin that conversation. If not, we may find ourselves with a regulatory program that in practice is too complex to realize the supervisory success to which we all aspire.

GETTING CAPITAL AND LIQUIDITY RIGHT

Today's focus on capital and liquidity brings to the fore factors that affect banks throughout their operations. They also have profound impact on the overall economy. Getting capital and liquidity right is important for local, State, and national economic growth and prosperity, because they affect both the amount of financial services banks can provide and the form that those services take. Economic growth and prosperity, by the way, are the business of banking. Banks prosper as their customers and communities do. Banks devote a lot of time and attention to capital and liquidity management because of their impact on growth and prosperity.

Since the trough of the recession, the U.S. banking industry as a whole has increased equity capital by more than half a trillion dollars. By the end of 2008, the low point of the financial crisis, industry equity capital had receded to $1.30 trillion, from a high point in March of 2008 of $1.36 trillion. At the end of the first quarter this year, bank equity capital had reached a record $1.84 trillion. Other measures of bank capital are comparably elevated, whether risk-based capital measures or risk-blind capital measures like the leverage ratio. Bank liquidity profiles and resources have been similarly augmented.

For U.S. banks, the fundamentals of safety are strong. But are they getting so strong that they are jeopardizing bank soundness? By soundness, I refer to other CAMELS measures, such as earnings and assets. Can a bank have too much capital, and, if so, what are the consequences? Without sustained and strong earnings, no amount of capital and liquidity will eventually be enough. Excessive limitations on assets mean limiting the financial services that banks are chartered by Government to provide. There is a balance here, and how to get that balance right is an important matter for policymakers and industry to consider. It is not academic.

CAPITAL IDEAS

We offer a few thoughts for that consideration.

Efficiency of Capital

After the trough of the recession, while the banking industry was building its capital by half a trillion dollars, bank assets—the banking industry's share of the economy—remained flat for several years and then grew by $2.4 trillion. That growth

is good and valuable, supporting broader economic growth and millions of jobs. But could there have been more? The new, additional capital has been, at least in the short run, relatively less efficient than normal in generating economic growth. The ratio of new capital to new asset growth has been just shy of one-to-five, each new dollar of capital supporting just under five dollars of new loans, leases, and other bank investments. At the trough of the recession, the $1.3 trillion of bank capital supported $13.8 trillion of loans, leases, and other bank assets and investments; that is to say that one dollar of capital supported almost 9 ½ dollars of loans, leases, and bank investments. Encouragingly, the latest results from the banking industry suggest asset growth related to capital moving in a direction toward historical norms. Is that a development for policymakers to arrest or to encourage?

Contractionary Effects

Increasing regulatory capital is contractionary. As we learn in the basics of money and banking, most of the money in a modern economy is generated by means of the banking system, through the process of banks taking in deposits and making loans. The Federal Reserve may create dollars, but depositors take those dollars and put them into banks. Depositors treat their deposit balances as part of the money supply. Banks lend those deposits back into the economy, which funds are used as money by the borrower for economic activity and which find their way back into banks as more deposits, again increasing the money supply, when they are lent yet again. It has been said that modern banking is the process of allowing the same dollar to be used and reused by several different people. Financing banks by deposits is expansionary, funding economic activity. Adequate capital supports that process as a base of confidence and a platform from which to take a chance on borrowers.

But raising capital standards is contractionary, because it takes dollars out of the system. Investors do not treat their capital investments as money. They do not use their capital investments to buy groceries, purchase furniture, go on vacation, or do the millions of other things for which deposited money is used.

That is not to diminish the importance and value of capital as a foundation on which banks are able to build and manage their activities, including that important function of converting deposits into loans and yet more deposits. While adequate capital allows a bank to expand its activities, excessive capital requirements mean pulling even more money out of circulation to provide the same amount of financial services, more capital to do the same amount of financial work. How much capital is really needed, and how do we know?

A Cacophony of Capital Measures

As a result of the variety of new prudential regulations in recent years, we have multiplied the ways in which we evaluate and measure bank capital. The largest banks are required to monitor more than a dozen capital dials, including the Standardized Common Equity Risk-Based Ratio, the Standardized Tier 1 Risk-Based Ratio, the Standardized Total Risk-Based Ratio, the Advanced Approaches Common Equity Risk-Based Ratio, the Advanced Approaches Tier 1 Risk-Based Ratio, the Advanced Approaches Total Risk-Based Ratio, the Leverage Ratio, and the Supplemental Leverage Ratio, among others. To this are added less-well defined but more demanding regulatory capital expectations under annual stress tests, such as the Comprehensive Capital Analysis and Review (CCAR), and a number of capital buffers, including the Capital Conservation Buffer and the Basel capital surcharge for Global Systemically Important Banks (GSIBs).

Surely a case can be made for each measure of capital and the information it provides, or that measure would not have been created and imposed. Do we really need all of them, however? Do so many measures of capital each have equal supervisory value? If they do not, do those measures with lesser supervisory value take some element of attention away from those whose supervisory value is greater, perhaps even vital? Would we improve the effectiveness of supervision if we identified and focused on those measures that provide the most value to prudential supervision? Is now a good time to be asking these questions?

Risk-Based and Leverage Capital

There is a purely academic debate that pits risk-based capital measures against leverage capital measures. In reality, bankers and regulators use both to evaluate the capital condition of banks. Risk-based capital measures have been criticized for being overly complex, subject to manipulation, and prone to error. All of these criticisms have elements of validity. Current Basel III—and other—capital measures are excessively complex, requiring calculations of details that exceed the supervisory value yielded. They do not have to be that way. Measuring capital according to risk can be simpler and still provide enough recognition of variation in asset quality to

be a valuable aid to capital management and supervision. Excessive complexity may facilitate manipulation, which is an argument for simplifying the risk measures, not eliminating them. It is easy to point to errors in the risk-based measures, most of which derive from excessive complexity (that presume too fine and precise the degree of risk predictability) and from the static nature of the risk-based measures, inadequately recognizing the dynamic nature of asset risk.

Similarly strong criticisms can be justly applied to risk-blind capital measures such as the leverage ratio. Both risk-based and leverage measures of capital are models. While acknowledging some degree of model error in risk-based capital, it should be understood that the leverage ratio is a model, too, one that assumes that all bank assets present equal risk. Whatever might be said about the likelihood of errors in risk-based measures, we can be certain that the simplicity of the leverage ratio means that it is always wrong. Unless a bank holds only one asset, its portfolio will contain assets with a variety of risks. The 1980s experience with the savings and loan industry demonstrates that this risk-blind simplicity can be manipulated by the unscrupulous to hide the riskiness of assets until the accumulation of risk becomes explosive. The risk-blind capital system that prevailed at that time allowed numerous institutions to run amok and contribute to the destruction of the Federal Savings and Loan Insurance Corporation, which had no measure of the degree of risk building up in the institutions whose deposits it insured.

A more sound capital management and supervisory program makes appropriate use of both risk-based and leverage capital measures, an approach adopted by all U.S. banking regulators and mandated by statute in the wake of the S&L crisis. Risk-weighting of bank assets is indeed imprecise, but it is an art that has shown valuable progress over the years. It avoids the proven dangers of treating all risks the same (under which safer banks are required to hold too much capital, and unsafe banks may be able to pass with too little). To counteract the model risks of risk-based capital systems, however, as well as to ensure capital for risks that are either unknown or unknowable, a foundation of leverage capital is merited. That is the structure that regulators and bankers rely upon today. It is demonstrably superior to reliance on either risk-based or risk-blind measures alone. Inasmuch as risks are dynamic, there is room for consideration of the right balance and improvements.

LIQUIDITY POINTS

Liquidity Is More Perishable than the Rules

Financial instruments are liquid until they are not. There is no class of financial instruments that has not had liquidity issues. Fannie Mae and Freddie Mac securities were once thought so liquid that serious consideration was given to using them as a monetary policy substitute for U.S. Treasuries, should the latter disappear as a consequence of prolonged budget surpluses. The budget surpluses did not last, and neither did the liquidity value of Fannie and Freddie financial instruments. The perceived reliability and liquidity of mortgage-backed securities helped fuel the mortgage/housing bubble. The insolvency problems of the Greek Government have reminded investors that sovereign instruments can become very risky. Even U.S. Treasury securities are subject to significant market losses in the event of an increase in interest rates, a problem made more acute by the Federal Reserve's prolonged suppression of interest levels, exposing Treasury investors to pronounced market losses from relatively minor upward movements in rates.

Unfortunately, the Basel-prescribed liquidity schemes implemented or proposed for implementation in the United States ignore the dynamic nature of liquidity. They are based upon static measures, financial snapshots of current liquidity conditions hardened into virtually perpetual standards. Are there supervisory and management methods to evaluate liquidity more dynamically?

HQLA, Concentration, and One-Way Liquidity

The Basel Liquidity Coverage Ratio (LCR), and U.S. implementing regulations, are intended to ensure that banks maintain enough liquidity to meet their needs for 30 days in a stressed environment. This basic prudential liquidity purpose is one that the banking industry supports. Liquidity, the ability to engage in transactions in a timely fashion and at reasonable cost, is essential to banking. Like oil in a car engine, without enough the engine soon locks up and ceases to operate.

Liquidity management, therefore, has been a perennial focus of bank management and regulatory supervision, part of the CAMELS evaluation for all banks, as I mentioned above. The LCR was promoted as an effort to standardize liquidity supervision for larger banks according to global rules applied locally. Kept at a level of focus on central principles of liquidity management, the global LCR standards could have been useful. Unfortunately, the Basel experts went well beyond that, into micromanaging liquidity supervision. Liquidity problems are all about panic, and

panic is a local, idiosyncratic matter. It is affected by local laws, national financial structures, even by local customs and attitudes. Some of these globally determined details do not fit realities in the United States very well, impacting the markets in which all of our banks operate.

For example, under the LCR, U.S. banks are required to assume that during a recession or financial stress banks will suffer a significant run on deposits. Maybe that was the experience in Europe or other places the Basel experts call home. The U.S. experience has been more generally the opposite. During the recent recession, our banking industry saw an influx of domestic deposits, by $813 billion from immediately before the start of the recession in December 2007 until its official end in June 2009, as bank customers looked to banks as a safe haven to place their money. Yet, under the LCR, U.S. banks are forced to pretend, and engage in liquidity management that assumes a fictitious major run off in business deposits. Large banks are encouraged by the LCR to increase their gathering of retail deposits, in competition with community banks. That is worse than wasteful, as it distorts markets and distracts bankers and regulators from a better focus on what are more realistic challenges to liquidity in the U.S. environment.

That is not the worst problem. The current structure of the LCR is excessively pro-cyclical, likely to hasten and deepen recession. The LCR requires banks to concentrate holdings in a static and narrowly defined list of what are called "High Quality Liquid Assets" (HQLA). The definition is basically short-term Government securities, with a smattering of highly rated corporate debt (deeply discounted). Recently the Federal Reserve added some municipal securities to the definition of HQLA (also deeply discounted), a move not yet echoed by the FDIC or the Office of the Comptroller of the Currency.

If during a time of stress there is not enough HQLA to meet liquidity needs, what will happen? Panic. The LCR makes specific minimum ratios of bank holdings of High Quality Liquid Assets mandatory. What appears liquid today, however, will likely become only one-way liquid in a recession or even the approach to recession. In prosperous times, short-term Treasuries are easy to buy and to sell. In times of stress, who will be willing to let go of their supply? Those that have a supply cannot be sure how much regulators will want them to hold as recession unfolds. Those that do not have enough will have trouble finding it.

If they cannot get needed HQLA, they will be forced to halt any expansion of loans and may even need to shed business in order to keep the mandated ratio of their assets in line with whatever amount of HQLA that they are able to find. Moreover, as noted earlier, U.S. banks typically see an influx of deposits during times of stress, which deposits will be difficult for a bank to accommodate if it is unable to acquire the additional supporting HQLA required by compliance with the LCR (see further discussion, below).

Bear in mind that, at the same time, other regulations will be driving financial actors to acquire and hold these same short-term Treasuries for other mandatory purposes. Recent money market mutual fund rules allow at-par pricing and redemptions only for funds that invest in Government securities, and these same Government securities are the primary asset recognized by regulations mandating collateral for swaps transactions.

With many sources of demand, HQLA will become scarce when financial storm clouds gather. That scarcity will affect economic activity, accelerating the slide toward recession, and sharpening a recession once begun. Does the static definition of HQLA miss assets that can have important liquidity value under certain circumstances? Is it wise to fix in regulation the assumption that Government securities will always be highly liquid under all conditions?

Where Will the Depositors Go?

Banks like to receive deposits and put them to work. A core function of banking is the reception of deposits from individuals, businesses, and government entities. We question the wisdom of liquidity regulations (the LCR) and capital rules (particularly the leverage ratio) that discourage banks from taking in deposits and that make it harder for banks to put those deposits to work.

In particular, these regulations disadvantage business deposits and deposits from municipal governments. The LCR assumes, opposite to U.S. experience, that significant amounts of business deposits will move out of banks during periods of stress. With municipal deposits, the LCR in effect imposes a double charge. Municipal deposits are required by most State laws to be collateralized, however the LCR will require banks to apply additional HQLA if the State-approved collateral does not meet the LCR's narrow definition of "highly liquid." Is it appropriate regulatory policy to discourage banks from accommodating business deposits and municipal

deposits, particularly in times of economic trouble? Do we no longer want banks to perform this traditional function?

To this are added punitive capital rules. These deposits are steered into high levels of HQLA, which, if a bank can get the HQLA, provide very low returns to the bank. In the second of a one-two punch, the leverage capital ratio assesses to banks the same capital charge applied to assets with higher returns. Under given market conditions—such as those prevailing today—the earnings on the HQLA may barely, if at all, cover the bank's costs in taking in these deposits. The market conditions that prevail in a recession are likely to be even worse.

The result has already been that some banks have had to refuse deposits and/or charge some businesses fees for holding large deposits. In times of financial stress or even a recession, the supply of deposits seeking a safe haven in banks will likely be elevated (contrary to the regulatory assumptions of the LCR), opportunities to invest those deposits will wane, while bank earnings will be under increased pressure. In short, the new rules compromise the traditional practice of banks to accommodate deposits that they cannot readily use. Where will these depositors go? And what further strain will that place on economic activity? We believe that these are consequences, though already materializing, that neither banks nor policymakers intended. We need to address these dangers sooner than later.

NSFR: Static, Complex, and Plowing an Already Seeded Field

Much of what has been said about the problems with the LCR also applies to Basel's other liquidity prescription, the Net Stable Funding Ratio (NSFR), for which the U.S. implementing regulations were recently published for comment. The NSFR imposes static measures on dynamic activity, and by an order of magnitude the NSFR is more complex than the LCR. Moreover, the NSFR lacks a purpose. There is no problem that the NSFR would solve that is not amply addressed by other prudential regulatory regimes already in operation.

The NSFR requires banks to evaluate their assets according to a complex framework of static risk weightings. At the same time, the rule would require banks to assess their funding sources by another complex set of risk weightings. Then the banks have to compare the two and see what they get. These asset and funding risk weightings, and the regulatory costs that the NSFR would impose, will guide the direction of banking services, rewarding banks for some assets and funding sources, penalizing them for others.

Not only does that increase regulatory allocation of funding, but the risk measures are sure to become swiftly out of date. Unfortunately, like Dorian Gray, the NSFR relies upon an unchanging picture of liquidity while reality changes all around. The liquidity of any asset or liability is subject to variation. The NSFR is not. Based upon the Basel experts' judgment of conditions with which they are familiar, the NSFR would harden risk weightings into regulation and impose them on the future, regardless of what the future may bring.

One of the key themes in the NSFR scheme, is that the maturity of an asset should be more closely matched to the duration of its funding source. To the Basel experts, this may sound like a good idea. It misses, however, one of the important economic roles of banking: maturity transformation. The U.S. banking industry takes in trillions of dollars of very short-term funds—deposits and other short-term debt—which customers take comfort in knowing that they can withdraw as needed. Banks take those funds and lend them out for longer periods, much of them for years. The longer maturities of the loans make houses, cars, and educations more affordable for families by letting them pay over a longer period. Businesses borrow in terms of years to allow the acquisition of plant and equipment, the development of business activities and other projects, most of which take time to generate revenues.

Banks manage the risks involved in the difference between those needs. That is what banks do. The NSFR is hostile to that banking function. It rewards maturity matching, meaning that banks under the operation of the NSFR will be encouraged to lengthen the time that people commit their funds to banks while shortening the maturities of loans.

The banking industry objects, the NSFR being neither in the interests of savers, borrowers, or banks. If finalized as proposed, the NSFR will mean less funding from depositors and fewer loans. We ask whether that is what policymakers intend.

That is not to deny the risk in managing largely short-term liabilities funding longer-term assets. Banks constantly monitor their supply of deposits and other sources of funds, just as they do the conditions of their borrowers. Evaluating how banks perform these duties is one of the central jobs of bank examination.

It has also been the focus of a number of additional regulatory programs put in place over the 7 years that the Basel experts have been working on the NSFR. The

various regulatory stress tests put bank funding sources and assets through rigorously negative, and dynamic, scenarios to see how they stand up. Weaknesses are identified and addressed. In addition to the LCR, which assumes a severe stress, regulators have developed and apply a Comprehensive Liquidity Assessment and Review (CLAR) to the largest banks, that annually evaluates current and anticipated future liquidity conditions on a dynamic basis. In addition, under form FR–2052a the largest banks daily report their liquidity positions, with monthly reporting for other banks having more than $50 billion in assets. The Federal Reserve's form FR–2052b is employed to monitor liquidity in banks with more than $10 billion in assets but less than $50 billion.

In short, the NSFR would plow ground that has already been seeded by more effective, appropriate, and dynamic measures of short- and long-term liquidity. Can we apply finite supervisory and management resources and attention to more fruitful prudential tasks?

RECOMMENDATIONS

Consistent with these principles and observations, ABA offers the following recommendations.

Highly Capitalized Banks and Basel III

In an overly complex way, Basel III capital rules require banks to hold adequate levels of high quality capital—capital with a demonstrable capacity for absorbing losses. As implemented by U.S. regulators, the final Basel III rules have been in some valuable ways tailored to bank conditions and business models. More can be done.

On September 15, 2014, the American Bankers Association and State bankers associations from every State and Puerto Rico sent a letter to the banking regulators recommending an additional element of tailoring. This recommendation stems from the recognition that a number of banks, primarily community banks, already hold high levels of capital. Recognizing that reality, our recommendation would not require any changes to law or to substance of the Basel III regulations. It would provide relief to thousands of banks, primarily community banks that are already holding levels of capital far and above what Basel III requires. (A copy of the associations' letter is attached to this testimony.)

The recommendation is simple. We recommend that bank regulators recognize that highly capitalized banks, namely any bank that holds approximately twice the level of capital expected by Basel III, be presumed to be in compliance with the Basel III standards without having to go through the complex—and unnecessary—Basel calculations. If you consider Basel risk-based standards, that would be approximately 14 percent risk-based capital; or if you consider the U.S. leverage ratio, that would be about 10 percent. We urge that the regulators employ tools already used by banks to identify these highly capitalized banks, rather than create a new onerous process to identify banks that would get relief from another onerous process.

For banks with that much capital, the Basel calculations would be a fruitless exercise, invariably discovering that the bank's capital levels were already far and above what the Basel rules would require. This recommendation would not have application to banks subject to the Advanced Approaches, since that process by definition involves a more detailed level of scrutiny.

We have had several discussions with bank regulators regarding this proposal and have found significant interest. We ask for timely implementation of this important step that would provide important burden relief while fully realizing the purpose of the Basel III capital regime.

Transparency and Due Process for International Financial Standards

The development and implementation of Basel III capital and liquidity standards was a painful process for all involved. It did not need to be that way. The public, the Congress, the broader U.S. banking industry were brought into the process too late, long after regulatory consensus was hardened, key concepts and formats already developed, and international deals reached.

Moreover, U.S. regulators participated in the international discussions with needlessly limited knowledge as to how the Basel plans would affect U.S. institutions, markets, and the overall economy. By the time that implementing regulations were proposed, U.S. regulators considered themselves committed to the global Basel plan and were reluctant to make more than minor adjustments.

We are still working our way through problems that could have been avoided if addressed at earlier stages in the process and had the regulators been equipped with more knowledge and public input. Examples would include the static and dangerously narrow band of HQLA, the punitive treatment of mortgage servicing assets

(that resulted in the shedding of mortgage servicing from banks to nonbank parties whose lower-quality service has been the subject of notoriety, regulatory inquiry, and borrower discomfiture), penalty treatment for investors in banks organized under subchapter S rules (whereby investors in Subchapter S banks that are subject to dividend restrictions to rebuild capital, find themselves paying taxes on dividends never received), and harsh treatment of investments in Trust Preferred securities, TruPS (contrary to congressional intent that existing TruPS investments be allowed to wind down without further regulatory penalties).

ABA recommends that financial regulators adopt or Congress mandate the following administrative practice: prior to the initiation of such international negotiations on financial standards, the U.S. agencies concerned should involve the public, the Congress, and affected industry through the publication of an Advance Notice of Proposed Rulemaking (ANPR). We believe that the ANPR should address and invite comment on the following items, among other pertinent matters——

- The issues or problems to be addressed by international standards;
- The nature of the standards being considered for application in the United States or affecting U.S. citizens or businesses;
- The various options likely to be considered; and,
- The anticipated impact of such options on U.S. persons, businesses, and the economy overall.

We believe that this requirement should apply to internationally developed financial standards in general, whether affecting banking, insurance, securities, derivatives, or other financial products and services.

This would not be an unusual procedure. Regulators often rely upon ANPRs to gather information prior to developing regulatory proposals. Negotiation of international trade agreements normally begins with significant public consultation and congressional involvement. The Basel II capital negotiations involved significant public consultation, improving the approach, providing greater tailoring of application, and collectively enhancing our understanding of risk based capital measures. It is true that the consultations resulted in a pause in potential U.S. implementation of Basel II, but with hindsight it is fair to describe that delay as salutary, since the recession did not catch U.S. banks in the midst of major capital restructuring. The U.S. banking industry entered the recession with a strong capital position that supported continued lending throughout most of 2008, and which industry net capital levels were only mildly impacted in the latter half of that year. Not only would the public and industry be more informed and Congress more involved in major financial policymaking with advance public notice, but the regulators themselves would be operating from a stronger base of information in the international discussions.

The NSFR: Already Done That

The NSFR, discussed above, is at best an outdated proposal that has since been overcome by other and better regulatory structures. ABA recommends that the proposed rule be withdrawn. U.S. regulators should, in fact, find that the purposes—if not the formalities—of the international standard have already been achieved in the United States by other liquidity supervisory and management regimes put in place while the NSFR standard was in development.

TruPS and Basel III

Prior to the recent recession it was believed, with regulatory concurrence, that trust preferred securities (TruPS) could serve as an additional and valuable source of capital, particularly for community banks. The recession demonstrated that while that might be true in the case of an individual troubled bank, TruPS had little loss-absorbing capacity when the entire banking sector was under strain.

In the enactment of the Dodd-Frank Act, Congress took two major steps with regard to TruPS and capital. The first was to end the future use of TruPS as capital. The second, to prevent unnecessary harm to the existing issuances and holdings of TruPS by community banks, was to hold existing TruPS harmless, letting them run off as they matured. The regulators tested this congressional purpose in the initial Volcker Rule regulation but subsequently revised their rule to carry out Congress' hold-harmless intentions. Unfortunately, in the Basel III implementing regulations, TruPS are targeted for punitive treatment. ABA recommends that Congress' hold-harmless approach to existing TruPS be applied in the Basel III regulations as well.

Most international regulatory standards, such as those developed by the Basel Committee, are at least initially announced as being designed for internationally active banks. When U.S. regulators choose to expand the reach of these global

standards to the entire banking industry—as they did with Basel III—the rules can have a disproportionate and unexpected impact on community banks.

TruPS instruments previously qualified as regulatory capital for the issuing holding company, and are securities in which a number of banks invested in good faith. Some smaller institutions accessed the market for these securities by pooling their issuances with those of other community banks.

Under the pre-Basel III capital regime, most pooled TruPS were assigned a capital requirement based on the credit quality of the pool, using a ratings-based approach. Under Basel III implementing regulations, however, the U.S. regulators treat any amount of TruPS investments above 10 percent of a bank's common equity as a loss, deducted from regulatory capital regardless of actual performance. As a result of the Basel III treatment, many hometown banks with TRuPS in their investment portfolios are seeing their capital requirements for their TruPS investments skyrocket.

This treatment of TruPS is inconsistent with the intent of Section 171(b)(4)(C) of the Dodd-Frank Act, which holds harmless existing TruPS investments. That congressional intent was eventually reaffirmed by the banking regulators when they backed away from an initial provision of the final Volcker Rule regulation that required banks to divest their trust preferred securities holdings, forcing thousands of otherwise healthy community banks to consider selling these assets at fire sale prices. About a month later, the banking agencies issued an interim final rule providing relief to banks that had invested in TruPS, citing congressional intent to hold harmless existing investments in the TruPS market. The Basel III capital deduction operates in a contrary direction, strongly encouraging the very divestiture treatment of TruPS investments that was overturned in the 2014 interim final Volcker Rule.

It is not clear why the regulators weighted Congressional intent so lightly, but it is clear that the Basel III treatment should be revisited if congressional intent is to be preserved and existing investments in TruPS indeed held harmless.

SUMMARY

The capital and liquidity positions of the banking industry are strong. The task list of prudential regulatory reform is approaching completion. Some reforms have been in place for several years, some are more recently in place, while a few remain to be finalized. Meanwhile, more and sustained economic growth are needed. The regulatory operations have been taking place on a living patient, whether you refer to the banking industry, the customers served, or the economy overall. We believe that the time is opportune to have a conversation involving all concerned about how all of this is working. What has been effective? What can be more effective? Are there provisions that are not working as expected or intended? We have offered several issues that we hope will be, and need to be, part of that consideration, particularly with regard to capital and liquidity.

The rules are complex, we suggest more complex than they need to be to achieve their important prudential purposes, too complex for regulators and regulated alike. We believe that appropriate and well-considered simplification—with an eye always fixed on accomplishing the purposes of the prudential rules—can enhance both supervision and management. Part of that simplification should include further tailoring of these regulations to the various business models of our very diverse banking industry.

In that context, we offer four specific recommendations, in addition to the issues and questions that we have raised:

1. Banks that are holding high levels of capital should be recognized as already meeting Basel III capital standards, without having to go through the complex Basel III calculations.
2. Prior to the initiation of international negotiations on financial standards, the U.S. agencies concerned should involve the public, the Congress, and affected industry through the publication of an Advance Notice of Proposed Rulemaking (ANPR).
3. U.S. regulators should withdraw the proposed rules implementing the Basel NSFR liquidity regime, having no purpose that is not already met by existing liquidity supervisory programs and tools.
4. The treatment of TruPS under Basel capital rules should hold existing TruPS issuances and investments harmless, as was the intent of the Congress in the Dodd-Frank Act, and followed by the banking regulators with regard to implementation of the Volcker Rule.

The American banking industry is eager to engage in the conversation that we have recommended. Supervision and bank management can be rendered even more

effective, which will be better for regulators and the regulated, and for the people whom we all serve.

September 15, 2014

The Honorable Janet L. Yellen
Chair
Federal Reserve Board
Eccles Board Building
20th and C Street, N.W.
Washington, D.C. 20551

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

The Honorable Thomas Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, D.C. 20219

Re: Application of Basel III Capital Rules to Highly Capitalized Banks

Dear Chair Yellen, Comptroller Curry, and Chairman Gruenberg:

The banking industry is firmly committed to effective capital standards that require banks to have adequate levels of high quality capital. We understand this to be the purpose of the Basel III capital standards and the implementing regulations. We embrace that purpose.

For many banks it does not require the implementation regime of hundreds of pages of rules to convert that purpose into reality. Many banks today maintain capital levels far in excess of any amounts that would be required even after a fulsome application of the complex evaluations, measurements, and calculations mandated under the Basel III regulations. For those banks, this considerable and costly work would yield no additional supervisory or safety and soundness benefits. Neither would it provide any service of any kind to any potential bank customer.

We propose that this wasteful and unnecessary effort be set aside, with no diminution in the value of the new capital standards contained in the rules. We propose that highly capitalized banks be allowed to continue to apply existing Basel I standards to the measurement and evaluation of their assets, while applying the new Basel III standards to the definition of what qualifies as regulatory capital. We propose that these highly capitalized banks be defined as those banks that have a common equity tier 1 risk-based capital ratio of at least 14%, measured by the Basel III definition of capital and the Basel I measures of assets that banks have been applying for many years. At 14% a bank would be holding twice the capital that would be required under Basel III, even after the additional 2.5% capital conservation buffer is added to the CET1 risk-based capital standard.

This proposal is not intended to reduce the amount of regulatory capital banks need. It is designed to be a regulatory relief measure for banks that can demonstrate they have significantly more regulatory capital than the new Basel III standards require. We believe that this proposal would reduce regulatory burden for these banks by reducing staff time, outside audit costs and

even examination time at these highly capitalized banks. Nor does this proposal require a rewriting of the Basel III regulations; it merely identifies those banks for which the asset measurements of those requirements are superfluous.

When the international capital regime was developed in Basel, these highly capitalized banks were not envisioned. We propose that they not be unnecessarily burdened as the Basel III standards are applied. We seek the opportunity to explore this proposal with you in greater detail at the earliest opportunity, as the demands for applying the full panoply of Basel III implementation structures fast approach.

Sincerely,

American Bankers Association
Alabama Bankers Association
Alaska Bankers Association
Arizona Bankers Association
Arkansas Bankers Association
California Bankers Association
Colorado Bankers Association
Connecticut Bankers Association
Delaware Bankers Association
Florida Bankers Association
Georgia Bankers Association
Hawaii Bankers Association
Heartland Community Bankers Association
Idaho Bankers Association
Illinois Bankers Association
Illinois League of Financial Institutions
Indiana Bankers Association
Iowa Bankers Association
Kansas Bankers Association
Kentucky Bankers Association
Louisiana Bankers Association
Maine Bankers Association
Maryland Bankers Association
Massachusetts Bankers Association
Michigan Bankers Association
Minnesota Bankers Association
Mississippi Bankers Association
Missouri Bankers Association
Montana Bankers Association
Nebraska Bankers Association
Nevada Bankers Association
New Hampshire Bankers Association
New Jersey Bankers Association
New Mexico Bankers Association
New York Bankers Association
North Carolina Bankers Association
North Dakota Bankers Association
Ohio Bankers League
Oklahoma Bankers Association
Oregon Bankers Association
Pennsylvania Bankers Association
Puerto Rico Bankers Association
Rhode Island Bankers Association
South Carolina Bankers Association
South Dakota Bankers Association
Tennessee Bankers Association
Texas Bankers Association
Utah Bankers Association
Vermont Bankers Association
Virginia Bankers Association
Washington Bankers Association
West Virginia Bankers Association
Wisconsin Bankers Association
Wyoming Bankers Association

Testimony of Greg Baer
President
The Clearing House Association

"Bank Capital and Liquidity Regulation Part II:
Industry Perspectives"

U.S. Senate Committee on
Banking, Housing and Urban Affairs

June 23, 2016

Chairman Shelby, Ranking Member Brown, and members of the Committee, my name is Greg Baer and I am the President of The Clearing House Association and General Counsel of The Clearing House Payments Company. Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. The Clearing House Association is a nonpartisan advocacy organization dedicated to contributing quality research, analysis and data to the public policy debate.

The Clearing House is owned by 24 banks which provide commercial banking services on a regional or national basis, and in some cases are also active participants in global capital markets as broker-dealers and custodians. Our owners fund more than 40 percent of the nation's business loans held by banks, which includes almost $200 billion in small business loans, and more than 75 percent of loans to households. Reflecting the composition of our membership, throughout my testimony, I will focus on the effects of regulation primarily on U.S. globally systemically important banks, U.S. regional banks of all sizes, and the U.S. operations of foreign banking organizations with a major U.S. presence.

One might assume that eight years after the financial crisis would be a good time to assess the consequences of the established post-crisis regulatory framework. As I will discuss, however, the pace of regulatory change is not slowing, and there are pending or planned proposals – most never envisioned by the Dodd-Frank Act – that would fundamentally redouble or rework what has already been done. Thus, my testimony will have three parts:

First, a description of the core post-crisis reforms that clearly have made commercial banks more resilient and resolvable, yielding benefits that are worth their economic costs. These benefits are sizeable and quantifiable.

Second, a description of pending or recently enacted reforms that impose meaningful impediments to economic growth and access to credit by consumers and smaller companies, but provide few if any marginal benefits beyond what has already been achieved by the core reforms. In some cases these regulations are flawed conceptually or operationally; in others, their marginal benefit is small because they are duplicative (or triplicative) of other rules. And in many cases, a reform that might be reasonable for some has been applied on a one-size-fits-all basis to banks whose activities pose few if any relevant risks.

Third, a broader look at some of the cumulative effects of post-crisis regulation, both core and non-core. Chief among these are (i) a migration of risk-taking and traditional banking activities to less regulated and potentially less resilient financial market participants, (ii) a decrease in credit availability for small

businesses and lower-income individuals, and (iii) fundamental and unpredictable shifts in the structure of capital markets that are rendering them less conducive to meeting the funding needs of the economy.

I. Core Post-Crisis Banking Reforms

Core post-crisis banking reforms generally seek to achieve two goals: resiliency and resolvability. The former significantly reduces the chance of bank failure through heightened capital, liquidity and other resiliency measures; the latter establishes a legal and operational framework that ensures that any bank can fail without systemic impact or taxpayer assistance. Each of these is described in detail below.

a. Improvements to Resiliency through Enhanced Capital and Liquidity

One of the key lessons of the financial crisis is the critical importance of maintaining sufficient capital and liquidity levels to ensure that banks can absorb outsize losses and heightened liquidity demands that typically accompany periods of financial stress. Responding to that key lesson, banks have *significantly* increased the amounts of high-quality capital and liquid assets they hold on their balance sheets, and regulators have enacted a range of reforms that require that this dramatic increase in the resiliency of banks remain in place.

i. Current Capital Levels

The numbers speak for themselves. The aggregate tier 1 common equity ratio of TCH's 24 owner banks rose from 4.6 percent at the end of 2008 to 12.1 percent at the end of last year. In dollar terms, tier 1 common equity nearly tripled from about $326 billion to $956 billion over the past seven years.

As a benchmark for just how resilient large banks' capital positions have come post-crisis, consider the results of the Federal Reserve's stress test exercise (the "Comprehensive Capital Analysis and Review," or CCAR), which attempts to measure the ability of banks to withstand a severe economic downturn. For the 2016 exercise, banks must demonstrate how they would perform under a sudden and severe recession and coincident market crisis that features the following:

- A sudden jump in the unemployment rate of 4 percentage points (from 5 percent to 9 percent) during the first 4 quarters of the scenario, which is nearly twice as severe as the increase that occurred during the 2007-2009 financial crisis (when unemployment increased only 2 percentage points over the first year);
- A sudden decrease in GDP of more than 6 percentage points;

- An abrupt rise in the BBB corporate bond spread;
- A 50 percent drop in the equity market over four quarters, an 11,000 point loss on the Dow;
- For banks with substantial trading and processing operations, the abrupt failure of their largest counterparty; and
- The emergence of negative short-term interest rates.[1]

After this stress, large banks must meet a series of capital requirements, including a 4.5 percent common equity tier 1 ratio.[2] And they must do so assuming they do nothing to shrink their balance sheets, reduce their dividend, or postpone planned share repurchases – almost certainly deeply counterfactual assumptions. Thus, a large bank that passes the CCAR exercise not only has sufficient capital to avoid failure under historically unprecedented conditions – it must have enough capital to emerge from such an event resilient and doing business as usual.

ii. Core Capital Regulations

The level of capital that now exists in the U.S. banking system is not merely a transitory trend; a series of regulatory requirements either has driven these changes or prevents their reversal.

Increases in the quality and quantity of required capital. The financial crisis taught us that common equity should be the predominant component of tier 1 capital, as it is most effective at absorbing losses. Accordingly, the Basel III capital standards and U.S. implementing rules establish common equity as the predominant component of capital.

Emphasis on stressed rather than static measures of capital adequacy. Capital regulation now emphasizes stress testing to measure banks' capital adequacy. The first stress test deployed by the Federal Reserve was its Supervisory Capital Assessment Program (SCAP) exercise in 2009, which played a crucial role in ending the financial crisis. SCAP was subsequently codified in the form of the Dodd-Frank Act Stress Tests (DFAST) and the CCAR process

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1 *See* Board of Governors of the Federal Reserve System, *2016 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule* (Jan. 28, 2016), *available at* /www.federalreserve.gov/newsevents/press/bcreg/bcreg20160128a2.pdf

2 The quantitative assessment of a bank's capital plan also requires a tier 1 risk-based capital ratio above 6 percent, a total risk-based capital ratio above 8 percent and a tier 1 leverage ratio above 4 percent.

described above. As noted below, we have serious concerns about how CCAR is applied in practice, but believe that it is a core reform, as stress testing is an important and necessary tool for assessing the health of the banking system. In particular, stress testing represents a key improvement in supervisory practices because it incorporates a *forward looking*, *dynamic* assessment of capital adequacy, and is less reliant on static measures and recent historical performance.

Extension of bank capital requirements to major broker-dealers. Prior to the financial crisis, non-bank broker-dealers were subject to considerably less stringent capital regulation than banks. Through the course of the crisis, all large non-bank broker-dealers either (i) failed (*e.g.*, Lehman Brothers), (ii) were acquired by bank holding companies (*e.g.*, Merrill Lynch and Bear Stearns), or (iii) converted to bank holding company status (*e.g.*, Goldman Sachs and Morgan Stanley), such that all remaining large broker-dealers are now subject to bank holding company capital regulation. And given current regulation, it is difficult to imagine the emergence of a non-bank-affiliated broker-dealer of significant size.

Additional capital requirements. Improving the quality of bank capital and extending the reach of capital requirements may have been sufficient to forestall the last crisis, even at then-current capital requirements, but requirements have increased significantly as the denominator for capital ratios has been significantly expanded and the required ratios considerably increased. For example, Basel 2.5 more than doubled capital requirements for capital markets assets, and Basel III requires large banks to maintain a minimum risk-based common equity tier 1 ratio of 4.5 percent, as well as a "capital conservation buffer" of an additional 2.5 percent and for some banks a G-SIB surcharge which can range from 1 to 4.5 percent.[3]

iii. Core Liquidity Regulations

Large banks are now also dramatically more liquid, and thus substantially less likely to fall victim to a run by depositors or other short-term creditors. A recent FSOC financial stability report shows that the largest banks (which it defined as those with assets of $700 billion or more) now hold about 30 percent of their balance sheet in the form of liquid assets, nearly double the share they held pre-crisis.[4] This outcome has been driven by another of the core post-crisis reforms: the liquidity coverage ratio (LCR).

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[3] *See* 78 Fed. Reg. 62018 (Oct. 11, 2013) (final rule).

[4] *See* Financial Stability Oversight Council, *2015 Annual Report*, at 61 (2015).

The LCR requires banks to hold high-quality liquid assets (HQLA) sufficient to meet their potential peak funding needs over a 30-day period of severe idiosyncratic and market stress.[5] HQLA include cash reserves held at Federal Reserve Banks, U.S. Treasury securities, and a small set of other assets that can be sold for value even under extreme stress. In addition to the specific requirements of the LCR, the Federal Reserve also now requires banks to conduct monthly stress tests of their liquidity at overnight, 30-day, 90-day, and one-year horizons, at a minimum.[6]

A critical component of the LCR is how the stress scenario is calibrated, including the pace at which banks lose funding or are able to liquidate assets. As a procedural matter, commendably, the LCR stress scenario was explicitly designed to resemble conditions during the worst of the recent financial crisis, based on extensive empirical analysis, and subjected to public comment. Although we have concerns with a few specific aspects of the final LCR framework, as described below, we strongly support the general thrust of the LCR, as it will help to ensure that banks with complex funding strategies remain resilient in the face of future liquidity stresses.

b. Resolvability: A Successful Legal & Operational Framework to Resolve Large Banks without Taxpayer Support

Title I and Title II of the Dodd-Frank Act are core reforms that ensure that any banking organization can be resolved in a way that requires no taxpayer assistance and does not destabilize the broader financial system. For U.S. global systemically important bank holding companies (G-SIBs) engaged in substantial non-banking activities, this required a new framework, described below. For more traditional commercial banks that hold substantially all of their assets with an insured depository institution, the crisis showed that the FDIC possessed the necessary authority and expertise to resolve them, and major changes were not required.

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5 *See* 79 Fed. Reg. 61440 (Oct 10, 2014) (final rule).

6 *See* 79 Fed. Reg. 17240 (March 27, 2014) (final rule); 12 C.F.R. § 252.35.

i. The Legal Framework: Titles I & II and Single-Point-Entry Resolution

The Dodd-Frank Act established a legal framework for the resolution of a large banking organization, which the Federal Reserve and FDIC have implemented in a thoughtful way. For most U.S. G-SIBs, this progress includes the single-point-of-entry (SPOE) resolution strategy. Under the SPOE strategy, all of the losses across a U.S. G-SIB would be absorbed by shareholders and creditors of its parent holding company, which would fail and be put into a Chapter 11 bankruptcy or an FDIC receivership under Title II of Dodd-Frank.

The two principal benefits of this strategy are (i) making it legally and operationally feasible to impose losses on holding company debt holders, thereby vastly expanding the loss absorbency of the relevant banks, and (ii) allowing the material operating subsidiaries to remain open and operating, thereby minimizing the systemic consequences of a large banking organization failure.

ii. The Operational Framework: Resolution Stays on Financial Contracts and TLAC

Two significant developments have greatly enhanced the credibility of SPOE as a resolution strategy.

Resolution Stays on Financial Contracts. One potential shortcoming of the SPOE strategy was identified by regulators and market participants: if the parent holding company enters into a bankruptcy or resolution proceeding, then the counterparties of the holding company's subsidiaries might exercise "cross-default" rights and terminate their derivatives and similar financial contracts with the subsidiaries, and then seize and liquidate the collateral (even though the subsidiaries remain open, solvent and performing on their contractual obligations). This would drain liquidity from the group in resolution, and the sale of the collateral into the market at a time of stress could have systemic consequences, as it did in the financial crisis.

To prevent this outcome, each U.S. G-SIB has voluntarily adhered to the ISDA 2015 Universal Resolution Stay Protocol,[7] which provides for the explicit recognition of resolution stays on cross-default rights in financial contracts between and among the world's largest dealer banks. In order to extend this

[7] International Swaps and Derivatives Association ("ISDA"), Adhering Parties: ISDA 2015 Universal Resolution Stay Protocol (last updated June. 17, 2016), *available at* https://www2.isda.org/functional-areas/protocol-management/protocol/22.

systemic protection beyond dealer bank transactions, the Federal Reserve recently proposed a rule that would generally require G-SIBs to include resolution stays in financial contracts with *all* of their counterparties. The Clearing House strongly supports this proposal, as the inclusion of resolution stays in financial contracts will make it easier to implement an SPOE resolution.

Total Loss Absorbing Capacity. In order for SPOE to be effective, a firm must maintain sufficient loss absorbing capacity that can be bailed in to recapitalize the firm even after a massive loss, and that bail-in must be operationally feasible. The former is achieved by holding at the holding company level substantial liabilities that cannot run in stress (basically, equity and long-term debt).

Accordingly, the Federal Reserve has proposed a "total loss absorbing capacity" (TLAC) rule that would require U.S. G-SIBs to maintain minimum total loss absorbing capacity equal to 21.5 percent to 23 percent of its risk-weighted assets, and 9.5 percent of its total assets.[8] *The eight U.S. G-SIBs alone will be expected to maintain, on an aggregate basis, more than $1.5 trillion in total loss absorbing capacity.* The scale of this reform has not been widely appreciated.

Operational feasibility is achieved by minimizing the types of other holding company creditors, thereby avoiding disputes among creditor classes in bankruptcy. The Federal Reserve's proposed rule would limit the amount of short-term debt or other liabilities at the holding company, and make clear that operating liabilities of subsidiaries are senior to the bail-in/TLAC equity and debt at the holding company. Thus, a U.S. G-SIB's losses can be imposed entirely on the private sector without inducing the holders of the group's short-term debt or financial contracts to run, or the holders of its other operating liabilities to cut off critical services

Clear Evidence of Success

Investors and markets appear convinced that equity and long-term debt holders are fully at risk in the event of failure, and that government assistance will not be required, or available, to resolve a large banking organization. Put another way, they appear convinced that large banks are no longer "too big to fail." The spreads that debt markets charge large banks have risen dramatically from pre-

[8] I also note that while we strongly support the TLAC requirement in principle, we do have several key concerns with the specific way in which the Federal Reserve has proposed to implement TLAC in the United States. *See* Letter from The Clearing House et al. to the Board of Governors of the Federal Reserve System (Feb. 19, 2016), *available at* www.theclearinghouse.org/issues/articles/2016/02/20160219-tch-comments-on-fed-s-tlac-proposal.

crisis levels. A Government Accountability Office (GAO) study released in July 2014 stated, "[o]ur analysis provides only limited evidence that large bank holding companies had lower funding costs since the crisis and instead provides some evidence that the opposite may have been true at the levels of credit risk that prevailed in those years."[9] The GAO found that any premium in the interest rates (that is, lower rates) that banks pay to borrow in the bond market had been significantly reduced, eliminated, or even reversed. Indeed, in half of the 42 models they employed, larger banks actually pay *more* to borrow than mid-sized banks issuing publicly traded debt.

Similarly, the ratings agencies now rate debt in accordance with the market reality reported by the GAO. At the time of the 2014 study, two of the three large rating agencies had already eliminated any "uplift" in ratings of bank holding company debt because of anticipated future government support. Since then, the third rating agency has also dropped any uplift for bank holding company debt.

In this context, it is also worth noting that post-crisis, large bank assets have shrunk as a share of the total economy, and remained stable as a share of total bank assets. This is not necessarily good news – if this trend was making them less diversified and therefore more risky, it would not be cause for celebration. But because bank absolute size does appear to be a concern to some, we note the trend.

As reflected in the following chart, starting with the simplest measure – total assets – the data show that assets at the largest banks grew during the recent crisis (almost exclusively because of "rescue" acquisitions in 2007-08) but post-crisis are shrinking relative to assets at smaller banks, and the economy as a whole (as represented by GDP).

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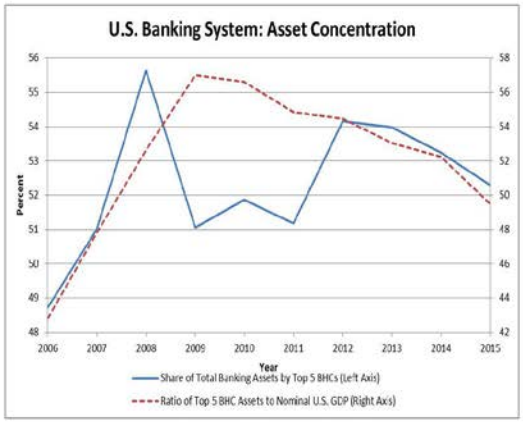
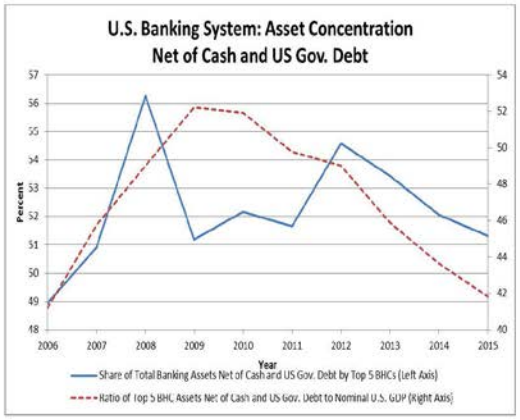
[9] Government Accountability Office, *Large Bank Holding Companies: Expectations of Government Support (GAO-14-621)* (July 2014) at 46. Academic research on post-crisis conditions is consistent with the GAO's findings. See also Javed Ahmed, Christopher Anderson, Rebecca Zarutskie, *Are the Borrowing Costs of Large Financial Firms Unusual?* (March 12, 2015), available at http://www.federalreserve.gov/econresdata/feds/2015/files/2015024pap.pdf



Even this presentation, however, significantly overstates the absolute and relative size of large banks post-crisis. As noted above, in the wake of the crisis, liquidity regulations required the largest banks (and only the largest banks) to increase dramatically their holdings of cash and cash equivalents. These assets can be readily sold in the event of a run, and their addition to the balance sheet makes the largest banks safer and sounder (and less profitable), not more risky. Deduct these assets, and one gets the *risk assets* held by the banks. Those assets are 10 percentage points smaller post-crisis.



Consider also how much risk the large banks are taking. Data here are harder to find in a way that can be aggregated, but the largest banks report their value-at-risk (VaR) as a common measure of how much they could lose in a day, with a stated confidence level. While an incomplete measure, it does allow for an apples-to-apples comparison over time. For the five largest reporting banks, their reported VaR for trading assets has declined on average by 63 percent since 2009.

II. Regulatory Measures that Yield Benefits Less than their Economic Costs

For the core reforms described above, it is reasonably clear that their benefits exceed their costs. But it is also clear that other current and pending regulations – or particular aspects or applications of those regulations – do not meet that test. Furthermore, in many cases, those costs are poorly understood and little measured.

Three keys to performing a regulatory cost-benefit analysis are as follows:

First, each regulation contains mandates and incentives that, while implicit rather than explicit, are nonetheless clear. Bank regulation necessarily favors some activities over others; thus, when regulatory requirements are calibrated at high levels, they create strong incentives for banks to no longer allocate their balance sheets according to actual economic risk but rather according to regulatory requirements. There is a common misperception that banks faced with a higher capital requirement can react in only three ways: accepting a lower return on equity, shrinking assets across the board, or increasing prices across the board. Under this view, regulation is agnostic or content neutral. In fact, large banks identify the business lines that are causing the higher capital (or liquidity) charge relative to actual economic risk, and then face a difficult decision of how much of that cost to require the business lines to earn back. As discussed in the third part of my testimony, we see dramatic evidence of this phenomenon in global capital markets businesses, where numerous large banks have either exited businesses entirely or dramatically reduced the amount of capital they are willing to commit to supporting market liquidity. Conversely, we have seen a strong trend globally for large banks to enter or expand private wealth management: this activity does not require significant capital or liquidity, and thus is a business smiled upon by the post-crisis regulatory regime.

Second, in assessing the benefit of a given rule against its cost, it is not sufficient to identify its standalone benefit. What is relevant is its *marginal* benefit – that is, what benefit it adds to the core reforms and others already enacted. For a rational cost–benefit analysis, it is not enough to simply say that a rule has the benefit of reducing the chances of a financial crisis like the last one:

the question is what that *marginal* benefit is, given the presence of other rules, and how it compares to the rule's cost (including that it might increase the chances of a financial crisis that is *unlike* the last one).

Third, in assessing benefits and costs, careful attention must be paid *to whom the rule applies*. This is because, in many cases, regulators have applied a particular reform to a wide range of banks on a nearly uniform basis. Such an approach to regulation, and to macroprudential regulation in particular, is inappropriate and inherently fails to account for the wide variety of business models and practices that exist among individual institutions. The application of prudential standards should not simply be a function of an organization's asset size, but should instead be based on the types of risk being run by the organization, driven largely by the types of activities it engages in.

Unfortunately, it is often exactly this untailored, size-based approach that has been taken in practice--much of the post-crisis prudential framework, including the Basel III capital and liquidity framework and the enhanced prudential standards established under Title I of Dodd-Frank, is not appropriately tailored to the diversity of banking organizations and business models that exist in the United States.

Below are some examples of recent regulations that raise these three sorts of questions.

a. Existing Capital Rules & Mandates

i. Supplemental Leverage Ratio

A leverage ratio measures the capital adequacy of a bank by dividing its capital by its total assets. Although the leverage ratio is seen as an alternative to risk-based measures of capital, the leverage ratio is in fact a risk-based measure of capital, albeit a bad one. It assesses the risk of each asset to be exactly the same – akin to setting the same speed limit for every road in the world. The risk of a Treasury security is assessed as the same as the risk of a loan to a startup with uncertain cash flows. The risk of holding a market-making portfolio of liquid, highly rated bonds is equated to the risk of holding a portfolio of illiquid loans to untested companies.

The inaccuracy of the leverage ratio – and the resulting misallocation of capital – has increased dramatically in recent years as a result of other regulatory mandates. As earlier noted, liquidity rules now require large banks to hold approximately 30 percent of their balance sheets in HQLA – predominantly cash, Treasury securities and other government securities. Large banks now hold

approximately three times as much of these assets as they did pre-crisis. Those assets rightly receive a zero or low risk weight in risk-based capital measures, but the leverage ratio completely ignores their actual risk – and creates a powerful disincentive to hold low risk assets beyond those required by regulation.

More practically, consider the combined effects of regulation on the decision to make a small business loan. That loan must be funded, and unless it is funded with retail or other very "sticky" deposits, the LCR requires the bank to hold HQLA (cash or cash equivalents) against that funding. While this treatment is appropriate, the leverage ratio then requires the bank to hold six percent capital against the HQLA which is not appropriate.[10] This increases the cost of making the loan – and unnecessarily so.

As another example, suppose an endowment wishes to make a deposit at a bank: that deposit is considered a run risk by the LCR, and so it requires HQLA; the LCR effectively imposes a six percent capital charge on the cash by requiring capital to be held against the HQLA.[11]

The impact of the U.S. leverage ratio is more pronounced on bank holding companies' capital markets activities, which are not funded by insured deposits. U.S. capital markets are the deepest, most liquid, and most efficient in the world, allowing U.S. companies as well as the government to finance growth and borrow more cheaply. At the heart of those markets are broker-dealers, which facilitate the issuance and trading of securities, and provide funding to other financial institutions. The broker-dealer business model involves holding well-hedged temporary inventories in low risk assets, as well as standing between borrowers and lenders in offsetting and well-collateralized repo transactions. Both activities earn only narrow margins; promote the liquidity and efficiency of financial markets; and entail little or no risk. However, both are balance-sheet sensitive; that is, they create assets on the books of broker-dealers -- assets that banks now have to fund in material part with expensive equity because of the supplementary leverage ratio requirement. Because of the thin margins earned in financial intermediation, the added cost from the supplementary leverage ratio requirement has a substantial impact on the amount of the activity.

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[10] Other large U.S. banks must hold a smaller (but by no means any more reasonable) 3 percent leverage capital against that same collateral.

[11] As discussed later, the disincentives do not end there: this transaction is considered short-term wholesale funding under the G-SIB surcharge calculation; also, while only a small part of the deposit is uninsured, the bank must pay deposit insurance premiums on the entire amount.

Another issue that has received recent notice is how the leverage ratio is working in opposition to the regulatory push for central clearing of derivatives. The leverage ratio requires banks to hold capital against client margin collected and held in a segregated account that unquestionably reduces the exposure of the bank, which ignores the fact that such margin not increases a bank's risk. As a result, it effectively requires banks to hold un-economic amounts of capital when they trade with a client and then clear the trade. Because of this, at least three major dealers have exited the business. Accordingly, CFTC Chairman Massad has called for the U.S. leverage ratio to be amended to take account of segregated margin.

All that said, there is a case to be made for a leverage ratio at a certain calibration. As we saw during the crisis, there will be times when banks (and other actors) seriously misjudge the risk of an asset class, and therefore undercapitalize it. Furthermore, if that asset class is illiquid and opaque to the markets (*e.g.*, mortgages or mortgage-backed securities), then market confidence in risk-weighted measures will fall, and markets may resort to a leverage measure themselves.

Thus, there is reason to establish a minimum leverage ratio below which a bank cannot fall as a failsafe measure in the event of a widespread failure to measure risk. However, *this ratio should be set as a backstop, and not at a level that drives daily misallocation of capital in the economy, as any measure that ignores risk is bound to do if made a binding constraint*. Here, the Basel Committee appears to have struck a fair balance by adopting a minimum leverage requirement of three percent. For U.S. G-SIBs, however, the U.S. banking agencies have set the ratio at six percent for banks and five percent for their non-bank affiliates. Thus, these banks are currently required to hold $53 billion in capital against cash reserve balances deposited at the Federal Reserve, and an additional $15 billion against Treasury securities. These are assets whose value banks are at no risk of misjudging; the capital allocated to them could be far better deployed to lending or supporting market liquidity.

ii. The Collins Amendment

The Collins Amendment to the Dodd-Frank Act mandates that the minimum capital requirements and risk-weightings for any particular bank, including large banks, be the same as those that apply to all banks generally, and prohibits the banking agencies from lowering these requirements. The intent of Congress in enacting the Collins Amendment was clear: to establish a simple measure of competitive parity.

In implementing the Collins Amendment, however, the U.S. agencies have defeated the goal of competitive equity by requiring large banks not just to meet the minimum capital ratios applicable to small banks, but to meet those ratios *plus* the many buffers of additional capital that larger banks must hold under Basel III: a capital conservation buffer; a countercyclical capital buffer; and a G-SIB capital surcharge. This was not a step envisioned by the Dodd-Frank Act, and indeed was not even proposed initially by the agencies. Nor was it undertaken with any meaningful cost-benefit analysis. But its implications are significant. It means that the less risk-sensitive standardized framework for risk-based capital is not merely a prudential backstop, but instead can be the binding measure of risk-based capital. This in turn penalizes certain assets for which the standardized approach and its risk weights are over-conservative and punitive, including both retail and personal lending to individuals and wholesale lending to businesses. By doing so, the agencies' implementation of the Collins Amendment unnecessarily exacerbates and amplifies the adverse effects of both higher capital requirements and the risk-insensitivity of the standardized approaches.

iii. G-SIB Surcharge

The capital surcharge for G-SIBs is designed to reduce the likelihood of failure such that the expected loss of a G-SIB's failure is approximately equal to that of a large, but non-systemically important bank holding company. While the methodology used to estimate the G-SIB capital surcharge is reasonable in principle, we have recently released a research paper that identifies major shortcomings in its calibration.[12] For example:

> The Federal Reserve's white paper includes the largest 50 banks each quarter…, a sample size that extends to banks that are so small that their experience may not be relevant. For example, at the end of the sample period, the set of 50 banks whose earnings were used to calculate the G-SIB surcharge had assets as low as $24 billion. However, in a 2014 response to a GAO study, the Federal Reserve expressed the view that it is inappropriate to compare such small banks to G-SIBs. Specifically, the Federal Reserve noted, that "a bank holding company with $10 billion in assets is too small to make a meaningful comparison to a bank holding company with $1 trillion in assets... A bank holding company of $50 billion in assets would provide a more relevant comparison..."
> For example, the now defunct First City Bancorporation of Texas, one of the ten smallest banks in the sample at $11.2 billion in assets, failed in the

[12] *See* The Clearing House, *Overview and Assessment of the Methodology Used to Calibrate the U.S. GSIB Capital Surcharge* (May 2016).

> late 1980s because of its concentrated exposure to energy and agricultural markets. It was also geographically highly concentrated, with 59 of its 60 subsidiaries located in Texas. ...[I]nclusion of this bank in the sample accounts for 36 basis points of the G-SIB surcharge for an average G-SIB.[13]

As noted, the Federal Reserve has stated that the G-SIB surcharge is "designed to reduce a G-SIB's probability of default such that a G-SIB's expected systemic impact is approximately equal to that of a large, non-systemic bank holding company."[14] Thus, by definition, regulatory changes that reduce the systemic impact of a G-SIB's failure should reduce its G-SIB surcharge, but they do not. A company that holds sufficient TLAC to effectuate a SPOE strategy, agrees to the ISDA protocol, and increases its margin against uncleared swaps and security-based swaps – all measures that regulators have justifiably stated have materially decreased systemic risk – would incur the same G-SIB surcharge as one that did not.

Furthermore, the overstatement of the G-SIB surcharge also contains an implicit mandate: reduce the activities that add to the score, namely, capital markets activities. This mandate derives from the five factors that determine a G-SIB's surcharge under the binding U.S. standard:

- The *complexity* factor includes almost exclusively securities and derivatives assets held in market making;
- The *inter-connectedness* factor includes almost exclusively dealer-to-dealer trading assets held in order to hedge customer positions held in market making;
- The *cross-jurisdiction* factor includes almost exclusively cross-border dealer-to-dealer trading of the type captured by the interconnectedness factor;
- The *short-term wholesale funding* factor includes almost exclusively the funding of securities positions; and
- The *size* factor is not so exclusively focused on securities activities, but for the largest banks those assets constitute a large percentage of their total assets.

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[13] *Id.* at 11.

[14] Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies, Proposed Rule, Federal Reserve System, 79 Fed. Reg. 75473, 75475 (Dec. 18, 2014).

Thus, the only effective way for a firm to reduce its G-SIB surcharge is to reduce its market making and other activities that provide market liquidity and generally support capital markets.

iv. CCAR

The U.S. stress test is another important building block of the post-crisis banking regulations, and as noted above, we are in principle supportive of rigorous stress tests as a tool to assess the capital adequacy of large banks. At the same time, however, we have growing concerns about the Federal Reserve's CCAR exercise in practice, and in particular with the opacity with which the Federal Reserve designs its stress scenarios and then translates those scenarios into post-stress capital ratios.

The stakes here are significant. CCAR is becoming a binding constraint for most large banks, and thus has economic impacts. For example, by more severely stressing unemployment rate changes, the 2016 stress scenarios implicitly discourage small business lending and household lending, as these are the types of loans whose loss rates are most sensitive to increases in unemployment. Raising the exit post-stress minimum requirements would add to the discouragement.

One can think of CCAR as having three main components: (i) the stress scenario provided each year; (ii) the process by which the Federal Reserve decides how much each bank will lose, and thus how much capital it will have remaining, after undergoing that stress; and (iii) the minimum remaining amount of capital a bank must have left over after that stress.

First, while the Federal Reserve's own self-imposed standard states that the severely adverse scenario should consist of "a set of economic and financial conditions that reflect the conditions of post-war U.S. recessions,"[15] the 2016 stress scenarios assume a macroeconomic shock that is considerably more severe than the 2007-2009 financial crisis. In particular, the increase in the unemployment rate in the 2016 scenario is substantially more sudden than what was experienced during the 2007-2009 crisis, which is likely to cause credit losses to accumulate rapidly and in greater amounts over the stress period.

Second, in contrast to other jurisdictions, the Federal Reserve uses its own internal model(s) to estimate stressed credit losses and net revenues and provides virtually no detail regarding the specifications of these models.

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[15] *See* 12 C.F.R. part 252, Appendix A.4.

Third, banks are required to hold substantial amounts of capital post-crisis, and the Federal Reserve has said that it is considering even higher levels for some banks. These levels appear to presume an obligation for banks not only to remain safe and sound – and thereby survive a financial crisis – but to continue lending at a normal rate in the face of a crisis.[16] There is no basis in statute or history for such an obligation. Leaving that point aside, the CCAR post-stress capital levels are designed to reflect the capital that banks would need to operate and raise funding, but one would think that if a cataclysmic crisis of the type described in CCAR were to occur, large banks would have no trouble attracting deposits and other sources of funding, as it seems likely that under such circumstances, numerous small banks would fail, non-bank lenders would see their funding dry up and cease lending, and capital markets would be disrupted. It seems quite likely that G-SIBs with 4.5 percent common equity tier 1 will be a highly attractive credit in such a market. Thus, before raising post-crisis minimum requirements for large banks, we would encourage the Federal Reserve to analyze the impacts of a CCAR scenario on *other* market participants, bank and non-bank; analyze where that would leave large banks on a relative basis; and ponder what that means for the post-stress requirements.

CCAR also provides a useful example of a regulation that generally has been applied uniformly across a large range of banks with differing business models and risk profiles. As a result, and particularly in light of the immense operational and administrative burden that attends participation in CCAR, the various concerns I note are all the more pronounced for those banks with simpler balance sheets or smaller risk profiles, for whom the benefits of CCAR are likely to be significantly less in practice.

v. Countercyclical Capital Buffer

Perhaps the best example of a post-crisis capital requirement that would fail even the most basic cost-benefit analysis is the countercyclical capital buffer. The countercyclical capital buffer was developed by the Basel Committee and contemplates an additional capital requirement for larger U.S. banks of up to 2.5 percentage points so as to "protect the banking system from the systemic vulnerabilities that may build-up during periods of excessive credit growth."[17] The Federal Reserve has recently issued a proposed policy statement

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[16] *See* Daniel K. Tarullo, *Stress Testing after Five Years* (June 25, 2014), *available at* www.federalreserve.gov/newsevents/speech/tarullo20140625a.htm (noting that the design of CCAR "serves the macroprudential goal of helping to ensure that the major financial firms remain sufficiently capitalized to support lending in a severe downturn")

[17] 78 Fed. Reg.at 62018 (Oct. 11, 2013) at 62038.

describing when and why it might impose this buffer.[18] That proposal has serious legal and procedural problems, but I will emphasize here its fundamental conceptual problems. This untested capital requirement is simultaneously both too broad and too narrow to be effective as a macroprudential tool to limit the build-up of risks in a credit bubble – too broad, because it would levy a hefty capital charge against all bank activities, not just the ones posing heightened risk, and too narrow, because it would do nothing to address any risks that arise *outside* of the banking system. Indeed, one can imagine that such a capital charge would only serve to accelerate the build-up of systemic risks by creating strong incentives for risk-taking to migrate outside the banking system.[19]

vi. Ring Fencing for Foreign Banks

Most of the post-crisis reforms have been applied, appropriately, to the U.S. operations of foreign banks. In some cases, however, foreign banks have received treatment that has unnecessarily and adversely affected their ability to assist U.S. customers. Specifically, foreign banks with significant U.S. operations have been required by the Federal Reserve (but *not* the Dodd-Frank Act) to ring-fence their U.S. non-branch assets and place them into a U.S. intermediate holding company (IHC). The proposed TLAC rule makes it very difficult to fund the IHC, and other rules have imposed duplication of back office functions.

Subjecting foreign banks to this U.S.-style of mandatory, *ex ante* ring-fencing has two principal shortcomings. First, to the extent that foreign banks manage their capital and liquidity on a consolidated basis, these banks retain and rely on the flexibility to shift financial resources within the organization to their location of highest and best use, including – most crucially – to a particular

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[18] *See* 81 Fed. Reg. 5661 (Feb. 3, 2016); 12 C.F.R. Part 217.

[19] These flaws are becoming an increasing focus of public discussion: for example, Federal Reserve Bank of Cleveland President Loretta Mester has publicly noted the shortcomings of the proposed countercyclical capital buffer approach in terms of both its unpredictability and uncoordinated nature.*See* Loretta J. Mester, *Five Points about Monetary Policy and Financial Stability* (June 4, 2016), *available at* www.clevelandfed.org/newsroom-and-events/speeches/sp-20160604-five-points.aspx (noting that "the need to coordinate countercyclical macroprudential policy actions across multiple regulators in the U.S. adds a complication to effectively using such tools in a timely way" and describing the need to "devise ways to make the macroprudential tools more systematic and less discretionary." Similarly, Office of Financial Research Director Richard Berner has noted that "[t]argeted policies with clear, direct effects on a financial stability threat ... are preferable to general policies with diffuse effects (such as activating a countercyclical capital buffer)." Richard Berner, *Remarks at the Conference on the Interplay Between Financial Regulations, Resilience, and Growth* (June 16, 2016), *available at* www.financialresearch.gov/public-appearances/2016/06/16/conference-on-the-interplay-between-financial-regulations-resilliance-and-growth.

geographic or business operation in times of financial or market stress. Their ultimate strength resides in the ability to obtain support from the necessarily larger consolidated resources of the global enterprise. U.S.-style ring-fencing significantly undercuts this benefit and therefore could actually undermine financial stability.

Second, ring-fencing has an undesirable effect of layering multiple capital and liquidity requirements on banking organizations, thereby increasing the regulatory burden and complexity.

However, if U.S. policymakers continue down the current path, they should, at a minimum, abide by Congress's explicit direction in the Dodd-Frank Act to give due regard to the principle of national treatment and equality of competitive opportunity. They should also take into account the extent to which each FBO is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States. In addition, we would urge policymakers to heed Congress's specific direction to take into account differences among financial institutions based on their systemic footprints and risk profiles.

b. Explicit & Implicit Liquidity Mandates

i. Living Wills

The living wills required under Title I of the Dodd-Frank Act are a key component of the core post-crisis regulatory framework addressing resolvability. One particular aspect of the regulatory guidance issued for the next set of resolution plans, however, appears to limit unnecessarily the ability of banks to engage in liquidity transformation, one of their core functions. As noted in a recent article by our head of research,[20] the guidance requires each material subsidiary to meet its peak potential funding on a standalone basis, without regard to the aggregate liquidity resources of an organization. As a result, for some banks, the living will guidance may be the binding determinant of the amount of liquidity transformation a bank performs. The potentially profound impact of these new policies on economic and job growth may be one reason why the GAO suggested that the agencies should be more transparent about the criteria they are applying when determining if the living wills are credible.

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[20] *See* William Nelson, AM. BANKER, *Living Wills: The Biggest Liquidity Rule of Them All* (May 24, 2016), *available at* www.americanbanker.com/bankthink/living-wills-the-biggest-liquidity-rule-of-them-all-1081150-1.html.

ii. LCR

The LCR is a core post-crisis reform that, while successful and effective as a general matter, has components that appear to be calibrated inaccurately, with substantial economic impacts.

The LCR treatment of liquidity commitments is an excellent example. For a commercial bank, these commitments represent a valued service to their business clients, particularly small businesses that do not have easy access to capital markets. These businesses are unlikely to draw these lines in times of financial crisis, as they use the funds for regular business and not as a source of liquidity. During the financial crisis, data shows that draws on these lines of credit were a maximum of 10 percent. Under the LCR, however, banks are forced to assume that 30 percent of these lines will be drawn.

The result under the LCR is that a bank must hold 30 cents of HQLA – basically, cash or a Treasury or agency security – against every dollar of commitment it offers a nonfinancial business. In other words, the bank must increase the size of its balance sheet, thereby drawing higher capital charges under the leverage ratio –which ignores the riskless nature of the HQLA. Here, the implicit mandate is to shrink or raise the price of lines of credit to U.S. businesses, making it more difficult for small businesses to grow.

A similar situation occurs with respect to custody banks, which offer lines of credit to their asset manager customers. Asset managers prefer these lines of credit to holding cash to fund possible redemptions; again, counterfactual outflow assumptions in the LCR have caused the banks to shrink (or increase the price of) these lines.

Furthermore, the U.S. banking agencies have applied the LCR (either in full or in some modified fashion) to all U.S. banks with $50 billion or more in consolidated assets, as well as to the U.S. intermediate holding companies of foreign banks that meet the LCR's definition of a "covered company." But that broad scope of application again ignores the wide heterogeneity across those banks – particularly in terms of funding models. While the LCR in full form may be appropriate for firms with complex market funding strategies, it is often likely to be unnecessarily onerous, and not particularly beneficial for firms that are predominantly reliant on deposit funding.

c. Additional Reforms Pending

Given the extraordinary stringency and complexity of post-crisis regulation, it is somewhat surprising that the pace of regulatory change continues at a high, and continuously more burdensome level.

i. Basel IV Changes to Capital Regulation

Basel IV is an ongoing effort by the Basel Committee to reduce reliance on bank models in setting capital requirements. It has two components: (i) imposing floors on the amount of required capital that can be calculated using bank internal-ratings based (IRB) approaches; and (ii) the development (or redevelopment) of government-devised standardized measures of capital as an alternative to bank models. Basel IV has not been presented for debate in the U.S., even though it is being finalized on an international basis. The Clearing House believes that there are compelling reasons for the United States to opt out of any changes agreed to as part of Basel IV.

Basel III set global banking capital standards at a high level, and the U.S. regulators have consistently made them still higher for U.S. banks. In undertaking Basel IV, the Basel Committee consistently emphasized that the purpose of the exercise was to prevent inconsistent outcomes in bank models, not to increase overall capital from their Basel III levels. The problem is that in every case, the standardized models proposed by the Basel Committee would require dramatically more capital than the levels agreed to in Basel III. Of course, higher capital requirements could be appropriate if the simplified, standardized models were more accurate. But they are not more accurate, and they come with a host of other risks.

It is easy to understand why internal bank risk models have been disdained after a financial crisis that revealed serious errors in bank risk management; furthermore, there is a strong perception that some banks have underweighted the risk of some assets in order to lower their capital requirements post-crisis. But there appear to be multiple reasons to be still more skeptical of uniform, government-devised regulatory risk assessments. Make no mistake, these are "models" in the same sense as the bank models they would replace; and they similarly provide formulas for assessing risk and assign a corresponding capital charge. By design, they do so using simplified approaches that ignore important differences in the risk among assets. For example, a recent Basel Committee proposal on credit risk suggested that there is insufficient data to model loss rates on credit cards or large corporate loans, and therefore proposed to subject them to uniform floors implying an equal probability of default. Also, these standardized models are one-size-fits-all, assuming the risks are the same for all banks in all

markets in all countries; they are also as a practical matter incapable of adjustment as risk changes.

As regulatory requirements – and in particular, capital and liquidity requirements – become increasingly stringent and granular, they run the risk of creating such powerful allocative incentives that they effectively drive capital allocations. There are serious concerns with such an arrangement. First, markets generally are more efficient in evaluating financial risk than governments, and in any event are quicker to react to changes in risk. Second, government mandated outcomes tend to *herd* risk and thereby create concentrations.

Consider this question: *Has there ever been a systemic crisis as a result of one bank, or even a small number of banks, taking an idiosyncratic view of risk?* The most recent financial crisis is clear demonstration of the alternative case: banks, non-banks, government-sponsored agencies, and ratings agencies (and regulators) generally taking a consistently erroneous view of the risks of default on mortgages, a money market mutual fund "breaking the buck," a run on short-funded investment banks, and others. Crisis came when all came to recognize their common misperception. Similarly, the U.S. thrift crisis in the 1980s involved thousands of banks and thrifts taking a common view of real estate lending. Indeed, thrifts were required by regulation to hold a specified – one might say, standardized – percentage of their assets in mortgage loans. Thus, if one were asked to choose from a systemic, "macroprudential" perspective between regulators having as their imperative (i) ensuring all banks allocate their capital based on the *same* view of the risk of each asset, or (ii) ensuring that all banks allocate their capital based on *different* views of the risk of each asset, history would appear to argue for the latter.

This debate is certainly not unique to banking. Aircraft safety, health safety and national security are all vitally important, but we continue to let private sector firms design airplanes, pharmaceuticals, and ballistic missiles – subject to governmental testing and oversight.

It is also important to emphasize that the United States is unique in its approach to capital regulation, and least in need of a Basel IV. The CCAR process has clearly been identified as the Federal Reserve's primary tool for ensuring capital adequacy. The Collins Amendment has already established a mandatory standardized floor on capital requirements in the United States (and only in the United States). Furthermore, U.S. banks are now required to invest heavily in model development, employ an independent second line of defense to review the models, and a third line of defense (audit) to review as well; all models that feed CCAR or financials (and many that don't) are subject to prior review and approval

by the Federal Reserve or the OCC. Most other Basel countries have few if any of these safeguards.

The potential outcome of Basel IV could be significantly more perverse, however, if one considers that European and other banks subject to Basel IV will in fact *not* end up using the Basel IV standardized approaches but rather the alternative internal-ratings based (IRB) approach developed in Basel II. At that point, because CCAR uses standardized approaches, the U.S. banks could be the *only* banks implementing the Basel IV standardized approaches, and the only banks to see a potentially massive and unjustified increase in capital requirements.

ii. NSFR

The Clearing House is deeply skeptical that the Net Stable Funding Ratio (NSFR) liquidity requirement, which the banking agencies recently proposed, has benefits that exceed its likely costs. The NSFR is intended to measure banks' liquidity risk at a longer horizon than the LCR. The NSFR is defined as the ratio of "available stable funding" ("sticky" liabilities that are unlikely to run) to "required stable funding," (assets that are illiquid and cannot be readily sold to fund a run).

The NSFR is particularly concerning because it was developed by the Basel Committee without a completely transparent public review and comment process. A preliminary version of the NSFR was released by the Basel Committee for comment in January 2014; nine months later, the Committee published a final version of the NSFR that included significant new elements that were never subject to public comment. Even today, nearly two years later after publication of the final framework, it remains unclear what, if any, data analysis supports many of the calibrations selected by the Basel Committee in the NSFR. This lack of transparency and empirical justification is the foundation of the current rulemaking that the banking agencies proposed in early May.

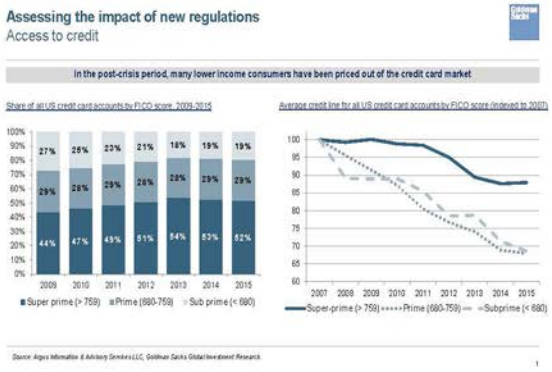
As a forthcoming TCH research note will demonstrate, once the level of interest rates and the size of the Federal Reserve's balance sheet normalize, banks will likely need to make substantial changes to their future balance sheets to comply with the proposed NSFR, likely at least in part by reducing, or charging much more for, activities for which the NSFR requires a high level of stable funding: primarily, lending to households and nonfinancial businesses, including small businesses. Because the regulation requires banks to hold stable funding against short-term lending to other financial institutions, it seems likely to also add further to the degradation in financial market liquidity that has been observed in recent quarters.

III. General Concerns

As the foregoing suggests, a significant redistribution of risk is occurring in our financial system, driven in part by post-crisis regulation. Risk taking in the regulated banking sector has been significantly reduced, even as banks' capacity for risk taking – as evidenced by much higher capital and liquidity levels – has increased substantially. In some cases, those risks are not being taken (*e.g.*, certain loans are not being made), leading to slower economic growth. In other cases, those risks are being taken by non-banks that are less regulated, less supervised, and less capitalized. Conversely, at the same time that certain higher-risk activities are being pushed out of the banking system, regulation is also driving banks out of the *lowest* risk assets and activities, which no longer make economic sense for many firms. As we evaluate both these regulatory causes and their practical effects on the new financial risk environment being created, there are several emerging, more general concerns that appear to warrant greater attention, each of which is described below.

a. Impact on Commercial Banking

For commercial banks, regulation is having significant effects on the extent to which banks can intermediate between savers and borrowers. Capital and liquidity rules are shrinking credit availability, particularly to small businesses (which cannot access capital markets and must rely on bank loans) and low to moderate income consumers. As an example, consider trends in credit card lending:



For individuals and sole proprietorships, credit card loans can be an important source of funding – and a lower cost source of funding than non-bank alternatives. Clearly, the availability of credit card loans for those with credit scores below super-prime has decreased significantly. Some reduction was natural and appropriate given crisis experience; the question is whether the pendulum has swung too far.

As another example, there is certainly a benefit to their safety and soundness from rules that require the largest banks holding to hold approximately 30 percent of their assets in cash and cash equivalents. But there are also certainly meaningful economic costs, as these are funds that cannot be lent to businesses or individuals. Moving to the standardized approach, a recent TCH study finds that banks subject to the Advanced Approaches would have to reduce about 15 percent of all loan commitments to offset the increase in capital requirements for off-balance sheet exposures proposed under Basel IV.[21]

To a large extent, the effect of a reduced role for banks in financial intermediation depends on the extent to which non-banks can serve as a substitute. There are reasons to be skeptical as we look to the capacity of nonbanks to fulfill that role both in ordinary times and in times of crisis.

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21 See "Empirical Analysis of BCBS-Proposed Revisions to the Standardized Approach for Credit Risk," The Clearing House, May 2016. *Available at* https://www.theclearinghouse.org/issues/articles/2016/05/20160520-tch-analyzes-bcbs-revisions-to-the-standardized-approach-to-credit-risk

First, even in good times, bank alternatives tend to be quite expensive. Whether in consumer (payday lenders, finance companies) or small business lending (online lenders), prices charged to consumers and businesses are extremely high. Indeed, as reported in a recent small businesses survey, borrowers are generally dissatisfied with online lenders, mainly due to high interest rates.[22] According to a recent study, many alternative lending platforms charge yields ranging between 30 and 120 percent on the value of the loan, depending on several loan characteristics.[23] In contrast, yields on loans funded by commercial banks range between 5 to 7 percent.

This higher cost pricing should not come as a surprise. Not only do banks have access to lower cost and more durable funding, they also generally have an informational advantage when it comes to lending. If they bank the borrower, they see cash flows over time, and are thus better able to gauge risk.

Second, one might well presume that in the event of economic trouble, these non-banks will see their own cost of funding increase markedly, as they would not have access to insured deposits and are generally of insufficient scale to access capital markets. Moreover, they will need this access just as their assets are declining in value, and are opaque to investors. Thus, one could well see the effects of a future recession amplified by the withdrawal of non-bank lenders from the playing field, much as we saw systemic problems arise from the failure of non-banks in the financial crisis.

b. Capital Markets

Capital and liquidity regulation have significantly affected capital markets activity. Somewhat surprisingly, the impact comes not only from the regulatory treatment of risk assets but also from the regulatory treatment of low-risk assets like cash and U.S. Treasuries, and ultimately the repo markets. Dealers find it more expensive to hold inventory and thereby provide market liquidity, because of the associated funding costs. Dealers find it even more difficult to serve clients who themselves provide market liquidity, because those clients fund purchases by pledging low-risk assets to the dealer, which regulations discourage the dealer

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22 *See* Federal Reserve Banks of New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond, St. Louis, 2015 Small Business Credit Survey (March 2016).

23 *See* Mills, Karen and Brayden McCarthy, *The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game* (July 22, 2014), *available at* http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf.

from holding. Thus, regulation is not only preventing trading banks from playing their traditional role as market intermediary, but also preventing them from funding other market participants that wish to trade and play a similar role.

Custodial banks provide the operating cash management accounts for investment funds and other institutional investors and are finding it increasingly challenging to accept certain cash deposits from customers. Current and future regulatory focus on this essentially riskless activity, potentially impeding custody banks' ability to provide traditional custody services, could have an adverse impact on financial stability by preventing custody banks from being able to accept cash deposits from their clients during a crisis, denying those clients a safe haven to preserve their capital and potentially worsening a run on the banking system.

Of course, overreliance on short-term wholesale funding was a major cause of the financial crisis, and post-crisis regulation had as a justifiable goal reducing such reliance. As always, the question is whether the marginal benefits of additional reductions are worth their marginal costs. In other words, at this point, is there greater concern that a large bank will fail because of an inability of its securities affiliate to roll over debt, or that financial markets have changed from a principal-based system (where dealers use their capital to make markets), to a more brittle, agency-based system (where dealers only match buyers and sellers), which will be much less resilient and systemically sound in crisis, and reduce the value of corporate debt in steady state? It is not clear that the U.S. regulatory community has meaningfully posed this question, let alone answered it. (There appears to be more appetite for inquiry in Europe, where the European Commission has recently completed a call for evidence on the effects of financial regulation on economic growth.)

Further mandates that will diminish market liquidity are on the horizon. Most pertinent here are the Basel Committee's Fundamental Review of the Trading Book, which will substantially increase the capital costs of trading activities, the NSFR, which will further penalize repo market and similar activities, and the potential incorporation of the G-SIB surcharge into CCAR, discussed above. Similarly, while not a capital or liquidity rule for discussion today, the Volcker Rule has the potential to further chill principal-at-risk market making, particularly in a market stress where it is most needed

In the meantime, bank dealers have already seen more than enough regulatory disincentives, and many are exiting businesses. Dealer inventory is shrinking, trade sizes are getting smaller, and trading is clustering in on-the-run issuance by only the largest companies, where liquidity is to be found. And this is leading small and midsize firms to issue less corporate debt, even as large firms are issuing more. An increase in the yields that corporate borrowers must pay

(because their bonds are less liquid) is already evident, though to some extent camouflaged by historically low interest rates.

In sum, regulation is significantly reducing the ability of banks and their affiliates to intermediate in financial markets. Increasingly, intermediation is being conducted through algorithmic or high frequency trading, but the speed of trading is not a substitute for putting capital to work. Such traders also do not have a client model. Thus, they have neither the resources nor the incentive to take on large trades at a time of stress, but rather will seek to match buy and sell orders in smaller amounts. As a result, volatility is likely to increase, and market inflation and sell-offs could be longer-lasting and more severe than they would have been in the past. Issuers may be temporarily prevented from issuing debt or equity, or may have to bear substantially higher issuing costs. Increased volatility also drives up the cost of derivatives used for hedging, which directly reduces overseas investors' appetite due to reduced local currency return on their investment.

Thus, when the next economic or financial crisis comes, there is reason for concern that large banks will become a systemic Maginot Line, extremely well-fortified, all but certain to remain intact, but playing little useful role in battling systemic risk.[24] We do not know what geopolitical shock or asset bubble will cause such a crisis, but the chances of its first victims being banks with three times the capital they held before the last crisis, and with much of their assets held in cash or U.S. Treasuries, appear extremely low. Rather, a shadow lending system that is undiversified, market-funded, and unsupervised would seem to be a more likely source of flagration and accelerant. And as crisis unfolds, we may see a combination of rules lead to financial markets suffering as banks not only play a much smaller role in providing market liquidity but also as a refuge for investors and depositors seeking safety.

In short, the current priority should not be reinforcing the Maginot Line, but rather exploring other sources of risk outside its borders.

c. Supervisory Control of Routine Bank Management Decisions

While the focus of today's hearing is capital and liquidity regulation, it should be noted that the highly prescriptive and detailed regulation of banks' balance sheets has been matched by an equally extensive, albeit much less transparent, series of regulatory and supervisory interventions into the governance and day-to-day operation and management of banks. The basic business of

[24] As a historical note, the southern terminus of the Maginot Line was in Basel.

running a bank is increasingly being subject to the opaque but binding dictates of individual supervisors and examiners. While one might assume that high capital and liquidity levels reduce the need for regulatory involvement in banks decisions on new product development and risk management, the opposite is occurring. While impossible to quantify, the economic effects here may be as great as in the capital and liquidity arena – particularly for smaller banks. Although the increasing involvement of supervisors and examiners in even the most routine governance and management matters is taken as fact in the industry, it is difficult to engage in public debate regarding this problem, as the majority of interactions are shrouded in the regulators assertion of the protections afforded "confidential supervisory information."

Recent experience with the supervision of so-called leveraged lending is a good example, as the effects on loan and economic growth here could be just as large as if a capital surcharge had been imposed. Leveraged loans are made to companies that carry a lot of debt and therefore represent a greater repayment risk, albeit one that banks have experience managing. Such companies also are frequently growing companies. Beginning in 2013, the banking regulators have issued a series of public guidance and "Frequently Asked Questions" documents that while styled as "supervisory expectations," have made clear that banks must substantially restrict lending to such borrowers. It appears that this guidance has been supplemented by further direction from examiners to banks that has had the effect of further limiting lending activities in the area – though I am unable to speak to any of those details as they are deemed by the agencies to be "confidential supervisory information," and therefore are immune to public scrutiny.

This continuing episode raises a series of questions. First, has the guidance constrained the perceived risk? Although the agencies' efforts in this area were motivated by concerns that leveraged lending activities could "heighten risk in the banking system or the broader financial system through the origination and distribution of poorly underwritten and low-quality loans," it is already becoming apparent that a bank-centric approach is simply shifting risk rather than limiting it. For example, recent research by a team of Federal Reserve Bank of New York economists illustrates that the guidance has had the effect of reducing bank activity in this area, but *increasing* nonbank activities.[25] Indeed, one academic has

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[25] *See* Sooji Kim, Matthew Plosser & João Santos, *Did the Supervisory Guidance on Leveraged Lending Work?* (May 16, 2016), *available at* www.libertystreeteconomics.newyorkfed.org/2016/05/did-the-supervisory-guidance-on-leveraged-lending-work.html#.V2f_Jk32Z9M.

rather aptly described this as "like a game of Whac-a-Mole, with new unregulated players popping up to fill the gaps."[26]

Second, were the regulators prescient in identifying a bubble in leveraged finance, and interceding to limit its supply to borrowers? While more research is warranted, it appears that leverage loans have continued to perform well, outside of the area of metals, mining, oil and gas – where loans of all types have performed poorly. (The March 2013 guidance did not identify that sector as particularly problematic.) Thus, one effect may have been to raise the cost and reduce the availability of bank credit across other sectors unnecessarily.

Third, how did the agencies decide which borrowers' access to credit would be restricted? The recent FAQs have required banks, in evaluating whether a company is leveraged for purpose of the new restrictions, to assume that all lines of credit are drawn, and ignore cash held by the company (and presume that the cash is not invested productively). This definition has led to high-credit-quality companies being labeled "leveraged" and thus subjected to special limits. What analysis did the regulators undertake to determine that markets, rating agencies, and lenders were underestimating the risk of these companies?

As Congress conducts oversight in the area of prudential bank regulation, this may therefore be a good case study for further transparency and analysis. It may also argue for the regulators providing notice and seeking public input before launching future such initiatives.

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The Clearing House believes that (i) there are a set of core post-crisis reforms that have made our banking system substantially more resilient and our largest banks resolvable; and (ii) there is a limited set of regulatory changes that could be revised or deferred that would leave core reforms largely untouched, meaningfully improve loan growth and financial market liquidity, promote financial stability, and do nothing to decrease the resiliency or resolvability of banks.

Thank you for the opportunity to testify before the Committee today. I look forward to answering your questions.

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[26] Steven Davidoff Solomon, N.Y. TIMES, *Obstacles in Regulators' Push to Reduce Leveraged Loans* (July 7, 2015), *available at* www.nytimes.com/2015/07/08/business/dealbook/balancing-act-for-regulators-seeking-to-curb-leveraged-loans.html?_r=0.

WRITTEN TESTIMONY OF
JENNIFER TAUB
PROFESSOR OF LAW
VERMONT LAW SCHOOL

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

"BANK CAPITAL AND LIQUIDITY REGULATION PART II:
INDUSTRY PERSPECTIVE"

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WITNESS BACKGROUND STATEMENT

Jennifer Taub is a Professor at Vermont Law School where she teaches courses in contracts, corporations, securities regulation, and white-collar crime. She earned a J.D. *cum laude* from Harvard Law School, and a B.A. *cum laude* from Yale College. Prior to joining academia, she was an associate general counsel at Fidelity Investments.

Professor Taub has researched and written extensively about the 2008 financial crisis. This includes the book, *Other People's Houses*, published in 2014 by Yale University Press, which includes a chapter dispelling the top ten myths about the financial crisis.

Professor Taub has not received any compensation in connection with her testimony, nor has she received federal grants or contracts. The views expressed in her testimony are her own and do not represent the positions of her law school or any other organization with which she is affiliated.

WITNESS TESTIMONY

Chairman Shelby, Ranking Member Brown, and distinguished members of this Committee, thank you for the opportunity to testify today. My name is Jennifer Taub. I am a professor at Vermont Law School. I offer my remarks today solely as an academic and not on behalf of any association.

The title of today's hearing, "Bank Capital and Liquidity Regulation" sounds terribly technical, seemingly a topic just for the experts. But it's not. Reducing excessive bank borrowing through higher capital requirements matters to us all.

Bank capital is much more than just numbers you can *count up* on a balance sheet. Bank capital is what we can *count on* to ensure a more stable financial system that serves the credit needs of American families and businesses. When banks borrow excessively — in good times they gain, in bad times, we *all* lose. If banks teeter and topple, lending tightens and the broader economy suffers. We see job losses, investment losses, and home losses. This is a hard lesson that we have learned — and *forgotten* — time and time again.

If we read and take financial historians seriously, we would understand that this time is not—and will not ever be—different. Financial crises share common elements. They typically result from the deflation of debt-fueled-asset bubbles.[1] After an asset bubble deflates, thinly capitalized banks that hold those assets collapse when depositors or other lenders withdraw their money. Even good assets cannot be sold at full price under stress. Government-backed rescues follow when leaders realize the collapse of a giant bank could cause cascading failures and more widespread damage.

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[1] *See*, Hyman Minsky, *Stabilizing and Unstable Economy* (Yale University Press, 1986); Martin H. Wolfon, *Financial Crises: Understanding the Postwar U.S. Experience* (M.E. Sharpe, 1994); Carmen M. Reinhart & Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton University Press, 2009) ("No matter how different the latest financial frenzy or crisis always appears, there are usually remarkable similarities with past experiences from other countries and from history"), Erik Gerding, *Laws, Bubbles, and Financial Regulation* (Routledge 2013), John Geanakoplos, "The Leverage Cycle 2," (Cowles Found. for Research in Econ., Discussion Paper No. 1715R, 2009), available at http://cowles.econ.yale.edu/P/cd/d17a/d1715.pdf ("In the absence of intervention, leverage becomes too high in boom times and too low in bad times. As a result, in boom times asset prices are too high, and in crisis times they are too low. This is the leverage cycle."), Robert J. Shiller, *Irrational Exuberance* Revised and Expanded Third Edition (Princeton University Press, 2016).

We were schooled in this too-big-and-too-leveraged-and-too-interconnected-to-fail problem in 2008. Let's recall that the U.S. government committed many trillions of dollars in direct bailouts and indirect backstops to rescue the system. Some will seek to assure you that this doesn't matter anymore, because most of the money was paid back. That is cold comfort for the more than six million families who lost their homes to foreclosure since 2008 and to all of us who are still struggling in an economy that is just beginning to pick up steam.

Wall Street quickly went back to "business as usual,"[2] turned record profits, and paid out large dividends to shareholders. These dividends represent money that could have been retained to build up capital. Meanwhile Main Street is still slowly recovering. As memories of the painful post-crash years fade, hopefully the political courage to take decisive action to prevent another future crisis does not diminish.[3]

Bank profits are now at an all time high. According to FDIC Chairman Martin Gruenberg, "FDIC-insured institutions earned nearly $164 billion in 2015, a new record."[4] Moreover, only eight failed. The timing could not be better to focus now on implementing much higher bank capital requirements.

Bipartisan Consensus on Capital

There is considerable bipartisan consensus on capital. Just two weeks ago, on June 7th, when this Committee initially held a hearing on this subject matter, Chairman Shelby began by emphasizing the importance of strong capital requirements to promote a safe and sound banking system and to avoid taxpayer bailouts. Similarly, Ranking Member Brown recognized during his opening remarks:

> Experts on the left and on the right agree that capital is a vital element of financial stability. Capital lessens the likelihood that an institution will fail. It lowers the

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[2] Joris Luyendijk, "How the Banks Ignored the Lessons of the Crash—Joris Luyendijk spent two years talking to hundreds of City insiders. They revealed how close we came to disaster – and how quickly finance went back to business as usual," *The Guardian*, Sept. 30, 2015 ("Seven years after the collapse of Lehman Brothers, it is often said that nothing was learned from the crash. This is too optimistic. The big banks have surely drawn a lesson from the crash and its aftermath: that in the end there is very little they will not get away with.")

[3] See Jennifer Taub, *Other People's Houses: How Decades of Bailouts, Captive Regulators, and Toxic Bankers Made Home Mortgages a Thrilling Business*, Paperback edition, (Yale University Press, 2015), p. xi.

[4] Martin J. Gruenberg, "The Impact of Post-Crisis Reforms on the U.S. Financial System and Economy," Speech to the Exchequer Club, Washington, D.C., June 15, 2016.

> cost to the financial system, and most importantly to the economy if it does. Requiring the largest banks to fund themselves with more equity will provide them with a simple choice: they can either 'fully internalize the risk' that they pose to the economy . . . or they can become smaller and simpler.[5]

With this level of agreement across the political spectrum, what then are the points of contention and indecision that make this a worthy subject for deliberation instead of bold action?

The ongoing debate seems to surround the following points (1) what do we mean by capital; (2) how much capital should be required, (3) are the arguments against higher capital valid, and (4) is capital a sufficient substitute for other regulations including related to liquidity?

What Do We Mean by Capital?

There are considerable differences in what we talk about when we talk about capital. I like to refer to capital as the non-risk-weighted equity capital ratio, what some call a "leverage" ratio. This calculation is an assets-to-equity measurement. Ideally, this would include certain off-balance-sheet items as assets. Sometimes when others talk about capital they might mean a risk-weighted measure of equity capital. This method treats asset types differently, reducing the amount of equity needed to fund them based on their perceived riskiness.

While a leverage ratio is a blunt instrument, it is simple and transparent, less subject to manipulation than a risk-weighted capital ratio can be.[6] While the risk-weighted- approach can complement the leverage ratio, it is not enough on its own. It has been subject to arbitrage and abuse.[7]

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[5] United States Senate Committee on Banking, Housing, and Urban Affairs, "Bank Capital and Liquidity Regulation (June 7, 2016) available at http://www.banking.senate.gov/public/index.cfm/hearings?ID=E4DB4F1F-2053-4E72-BEB9-2B47B3A04676

[6] See Anat R. Admati, "Where's the Courage to Act on Banks," *BloombergView*, October 12, 2015, available at https://www.bloomberg.com/view/articles/2015-10-12/where-s-the-courage-to-act-on-banks-

"Regulators focus on 'risk-weighted' and accounting-based capital ratios that, among their many flaws, rely on banks to assess the riskiness of their assets. Using off-balance-sheet accounting, derivatives and other tools, banks have become adept at manipulating these ratios."

[7] For example, before the crisis, in addition to a minimum leverage ratio, banks were subject to capital standards which imposed a minimum of 8 percent capital to risk-weighted assets. An asset with a 0 percent risk weighting would need no capital backing, and one with a 100 percent risk

To explain an equity capital leverage ratio, the following illustration might be helpful. Imagine that I wish to buy a small business for $100,000. I borrow $95,000 from my cousin and I pay the remaining balance to the previous owner in cash. After that transaction, my equity capital would be $5,000, the difference between what I own and what I owe. That's a 5% leverage ratio. Or stated different a 20-to-1 assets-to-equity leverage ratio.

If my cousin suddenly demands the money back, hopefully I can sell the business for at least the $95,000 I owe. If not, I've wiped out my capital and would be scrambling for other things to sell to fully pay back that loan. That's the downside of leverage.

However, if I can sell the business for $105,000, I've doubled my money, or in other words, achieved a 100 percent return on equity. This is the upside of leverage — the ability to transform a 5% increase in asset value to a 100% return on ones investment. Extending this metaphor, liquidity is about whether I have enough cash to fully pay back the loan to my cousin while I wait a bit to try to fetch a better price for that business.

Similarly, banks borrow money from their depositors and other lenders. They use this funding to make loans and buy other assets including derivatives. If their depositors or other lenders to the bank demand their money back and assets can't be sold at full value, the bank's capital cushion is supposed to absorb the difference. If it is too thin, upon insolvency, a bank may be shuttered and sold, or we the people may have to bail it out.

How Much Capital Should be Required?

The Dodd-Frank Act provides regulators with the tools to rein-in excessive borrowing as well as to take other steps to help prevent financial crises of the magnitude we experienced in 2008. Section 171 sets a generally applicable leverage ratio, and Section 165 requires the Fed to make rules for enhanced prudential standards, including

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weighting would need an 8 percent backing, meaning borrowing $92 to finance every $100 of such assets. Whereas mortgage bonds had been give a 50 percent risk weighting, after November 2001, they were given a 20 percent risk weighting. So, instead of being required to have 4 percent capital, they needed only 1.6 percent. In other words, they could borrow $98.4 million to purchase $100 million in private-label MBS if they had triple-A or double-A ratings. Meanwhile a whole mortgage loan still had a 50 percent risk weighing. *See Other People's Houses*, p. 232.

reduced leverage for the largest financial firms. The final rules have made the system safer, but not safe enough.

The current minimum 4 percent equity capital leverage ratio is too low. The future leverage ratios of 5 percent for our largest bank holding companies and 6 percent for their insured depositories, which have not yet gone into effect, will still be too low.

I concur with Professor Heidi Schooner who testified before this Committee at the June 7th hearing that "[w]hile adequate capitalization is central to the safe operations of financial institutions, little justifies the current low levels of capital required under banking rules."[8]

Anat Admati and Martin Hellwig recommend at least a 20 percent non-risk-weighted equity capital ratio, including in their book *The Bankers' New Clothes.*[9] In a letter to the *Financial Times*, together with other leading economists they argued for "at least 15%, of banks' total, non-risk-weighted assets [be] funded by equity."[10]

Others would go even higher. During a 2010 CNBC interview, Nobel Laureate Eugene Fama (who also signed the *FT* letter) said: "the only solution I see is to raise capital requirements on these firms dramatically. . . Maybe they have to go up to 40 or 50 percent so that this whole idea of these big firms failing is just taken right off the table. Let the stockholders bear the ups and the downs without having to pass it on to the taxpayers."[11]

Arguments Against Higher Capital

Opponents of higher capital requirements contend that it would be too costly. In their comprehensive paper, entitled, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Socially Expensive," Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer convincingly address many

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[8] Heidi Mandanis Schooner, "Top-Down Bank Capital Regulation," 55 *Washburn Law Journal* 327 (2016) (In her recent article, "Top-Down Capital Regulation," Professor Schooner argues for a system in which "capital ratios applicable to all banks would be set high—high enough so that the risk of undercapitalization is very small. The opposite risk, the risk associated with requiring excessive capital, would be addressed through a supervisory process, in which banks could be permitted, on a firm-by-firm basis, to operate below capital levels set by rule.")

[9] Anat Admati and Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It* Paperback (Princeton University Press, 2014), pp 176 - 187.

[10] Admati, et. al, "Healthy Banking System if the Goal, Not Profitable Banks," *Financial Times*, Nov. 9, 2010.

[11] "Father of Modern Finance Weighs In," *CNBC Squawk Box*, May 27, 2010.

of the arguments that are advanced in opposition to higher capital requirements. They challenge the contention that more equity funding for banks would restrict lending and would otherwise be costly to society. [12] They assert that greater equity would result in less distorted incentives and thus better lending decisions, for example. They conclude "that the social costs of significantly increasing equity requirements for large financial institutions would be, if there were any at all, very small."

In another persuasive article, Admati observes that: "Nothing about the business of banking makes it essential or beneficial for banks to operate with the very low equity levels they choose to maintain."[13] While most banks have at most a 6 percent equity capital cushion, by comparison, ordinary operating companies rarely have less than 30 percent.

Higher Equity Capital is Not a Free Pass

A healthy equity capital cushion is necessary but not sufficient. Moreover, allowing banks with a mere 10 percent leverage ratio a free pass from other crisis prevention and intervention rules is misguided. This is but one of the many faults with a bill that House Financial Service Committee Chairman Hensarling is introducing.

As but one example, liquidity also matters. In testimony before the Financial Crisis Inquiry Commission in 2010, Goldman Sachs CEO Lloyd Blankfein noted:

> Certainly, enhanced capital requirements in general will reduce systemic risk. But we should not overlook liquidity. If a significant portion of an institution's assets

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[12] See Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig, and Paul Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Socially Expensive," October 22, 2013 ("A pervasive view that underlies most discussions of capital regulation is that 'equity is expensive,' and that equity requirements, while offering substantial benefits in preventing crises, also impose costs on the financial system and possibly on the economy. Bankers have mounted a campaign against increasing equity requirements. Policymakers and regulators are particularly concerned by assertions that increased equity requirements would restrict bank lending and impede economic growth. . . We consider this very troubling, because, as we show below, the view that equity is expensive is flawed in the context of capital regulation. From society's perspective, in fact, having a fragile financial system in which banks and other financial institutions are funded with too little equity is inefficient and indeed 'expensive.'") available at https://www.gsb.stanford.edu/sites/default/files/research/documents/Fallacies%20Nov%201.pdf

[13] Anat R. Admati, "The Missed Opportunity and Challenge of Capital Regulation," Dec. 2015, available at http://financial-stability.org/wp-content/uploads/2016/03/2015-12_admati_challenge-of-capital-regulation.pdf

are impaired and illiquid and its funding is relying on short-term borrowing, low leverage will not be much comfort.[14]

Banks are still overly-dependent on short-term wholesale funding.[15] The collapses of both Bear Stearns and Lehman Brothers were precipitated by a "run on repo"—when the institutions that had extended short-term and overnight credit to the investment banks withdrew their financing. The continued reliance on this short-term, wholesale funding creates what Fed Governor Dan Tarullo and others call "fire sale" risk. While some of this risk might be mitigated by the Liquidity Coverage Ration rules, presently this is still a large market with more than $1.5 trillion in tri-party repo alone.[16]

As Fed Vice Chairman Tom Hoenig noted in April, the eight U.S. global systemically important banking institutions (G-SIBs) "continue to rely on wholesale funding, deposit-like money market funds, and repos, all of which are major sources of volatility in uncertain times."[17]

Conclusion

At the June 7th hearing, Chairman Shelby recalled that in 2006, he warned of the danger of thinly-capitalized banks and "how a crisis in the banking system quickly infects

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[14] Testimony of Lloyd Blankfein, The Official Transcript of the First Public Hearing of the Financial Crisis Inquiry Commission Hearing, January 13, 2010, p. 9.

[15] See, e.g., Daniel K. Tarullo, Member of the Bd. of Governors of the Fed. Reserve Sys., speech at the Americans for Financial Reform and Economic Policy Institute Conference, Shadow Banking and Systemic Risk Regulation (Nov. 22, 2013); Liz Capo McCormick, "New York Fed Says Repo Fire Sale Risks Not Being Addressed," *Bloomberg* (Feb. 13, 2014), http://www.bloomberg.com/news/2014-02-13/new-york-fed-says-repo-fire-sales-risks-are-not-being-addressed.html; Jennifer Taub, "Time to Reduce Repo Run Risk," *New York Times DealBook* (Apr. 4, 2014), http://dealbook.nytimes.com/2014/04/04/time-to-reduce-repo-run-risk/; Ryan Tracy, "Fed Officials Suggest Limiting Banks' Repo Exposure: Rosengren and Dudley Say Large Markets for Repurchase Agreements Could Cause Instability Again," *Wall Street Journal* (Aug. 13, 2014), http://online.wsj.com/articles/fedofficial-suggests-limiting-banks-repo-exposure-1407936002. According to a report on "Contagion," reliance on short-term, wholesale funding means a bank is "more likely to suffer distress" and "the best predictor of a bank's contribution to systemic risk." *Committee on Capital Markets Regulation, What to Do about Contagion?* 34–35 (Sept. 3, 2014), available at http:// capmktsreg.org/app/uploads/2014/09/2014-09-03-WDAC.pdf

[16] Federal Reserve Bank of New York Tri-Party Repo Statistics as of 04/11/2016 available at https://www.newyorkfed.org/medialibrary/media/banking/pdf/apr16_tpr_stats.pdf?la=en

[17] Thomas M. Hoenig, FDIC Board Meeting Statement of Vice Chairman Thomas M. Hoenig regarding 2015 Title I plans submitted by the eight domestic GSIBs, April 13, 2016, available at https://www.fdic.gov/news/news/speeches/spapr1316a.html

the rest of our economy." He also noted that with the 2008 financial crisis, it became apparent that "the amount of high-quality capital" at banks "was "insufficient." He asked whether banks today could withstand another financial crisis. Unfortunately, the answer to that question is no. Our top banks are larger than they were before the crisis, are permitted to borrow excessively relative to the assets they hold, are too opaque to regulators and their own executives, and remain overly dependent on short-term wholesale funding.[18]

Raising the minimum equity capital requirements dramatically could substantially improve the likelihood that individual bank failures would be self-contained. However, increased equity capital, alone, especially at the levels this Congress or the regulators are likely to implement, would not justify rolling back other protections.

In conclusion, more bank equity capital and better bank liquidity means less systemic risk and reduces the cost of crises. Increased equity capital makes banks less fragile and more capable of lending even after suffering losses. With banks reporting record profits, it's time now to act where there is consensus and substantially raise bank equity capital requirements.

Thank you for this opportunity to speak. I look forward to your questions.

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[18] Frank Partnoy & Jesse Eisinger, "What's Inside America's Banks?," *The Atlantic* (Jan. 2, 2013), http://www.theatlantic.com/magazine/archive/2013/01/whats-inside-americas-banks/309196/; Peter Eavis, "Regulators Size up Wall Street, With Worry," *New York Times*, (Mar. 12, 2014), http://dealbook.nytimes.com/2014/03/12/questions-are-asked-of-rot-in-banking-culture/; William Dudley, President of the Federal Reserve Bank of New York, said in 2013, "There is evidence of deep-seated cultural and ethical failures at many large financial institutions;" and in a 2014 interview he said, "Either the firm is not too complex, you can manage it, you do know what's going on. Or, if you don't know, that's sort of raising the question whether the firm is too complex to manage.").

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SASSE FROM REBECA ROMERO RAINEY

Q.1. I'd like to discuss contingent convertible capital instruments, commonly known as CoCo bonds.

- What lessons can be drawn from Europe's experience with CoCo bonds?
- Do you believe CoCo bonds can uniquely help a firm withstand significant financial distress? If so, how?
- How should Federal regulators treat CoCo bonds?

A.1. ICBA has no position on contingent convertible capital instruments.

Q.2. I'd like to ask about Federal Reserve Governor Powell testimony at the April 14, 2016, Senate Banking Committee that "some reduction in market liquidity is a cost worth paying in helping to make the overall financial system significantly safer."

- Is there also a risk that reducing liquidity in the marketplace also makes the marketplace unsafe?
- If so, how should regulators discern the difference between an unsafe reduction in liquidity and a safe reduction in liquidity?

A.2. ICBA believes that market liquidity is critical to averting future financial crises. While ICBA has no position on the post-crisis regulation of the fixed-income markets, which is the context of Governor Powell's comment, we believe that reduced liquidity could make the marketplace unsafe. As part of a cost-benefit analysis of proposed regulations, which ICBA believes should be mandated by statute, regulators should attempt to quantify any anticipated reduction in liquidity and weigh that against the anticipated benefits of the regulation.

ICBA generally supports the Federal agencies' liquidity coverage ratio (LCR) rule which requires the largest and most internationally active financial institutions that pose the most risk to our financial system to maintain a stock of "high quality liquid assets" (HQLAs) to meet unanticipated cash-flow demands. However, ICBA is concerned about the unintended consequences of several provisions of the LCR rule. These concerns include (i) the impact on the housing market of excluding Fannie Mae and Freddie Mac securities from the Level 1 definition of HQLA; (ii) the impact on municipal finance of the exclusion of municipal securities from the definition of HQLA; and (iii) the high outflow rate assigned to reciprocal brokered deposits despite their full FDIC insurance and the inconsistent treatment of reciprocal brokered deposits that originate with wholesale customers (40 percent outflow rate) and with retail customers (10 percent outflow rate). A high outflow rate means that banks have to hold more liquid assets against them. ICBA's

January 30, 2014, comment letter on the LCR proposal describes our position in greater detail.

Q.3. I'd like to ask about the various capital requirements that have been imposed after the 2008 financial crisis.

- Have Federal regulators sufficiently studied the cumulative impact—including on liquidity in the marketplace—of these various changes?
- If not, how should Federal regulators resolve this issue? For example, some have called to delay the imposition of new financial rules and regulations, to facilitate a broader study of these issues.

A.3. ICBA is deeply concerned about the impact of the Basel III capital rule on community banks and advocates for an exemption for banks with assets of less than $50 billion so that these banks may continue using the Basel I capital rules. In my testimony, I noted four aspects of Basel III that are of particular concern: (i) the risk weighting of loans that are classified as high volatility commercial real estate (HVCRE); (ii) the complexity the rule adds to the quarterly call report; (iii) the capital conservation buffer, especially its impact on Subchapter S community banks such as mine; and (iv) the punitive capital treatment of mortgage servicing assets. ICBA's concerns are detailed in my written statement. We do not believe the regulators sufficiently studied the cumulative impact of these changes before finalizing the rule.

Q.4. I'd like to discuss stress tests.

- How should policymakers balance the tension between providing more transparency and guidance to regulated entities about how to pass a stress test, and concerns that to do so would allow regulated entities to allegedly "game" these processes?
- Do stress tests accurately depict how a firm would perform during a financial crisis, when taking into account "systemic" considerations? If not, what should be done, if anything, to improve their accuracy?

A.4. ICBA supports a full exemption from stress test requirements for nonsystemically important financial institutions (non-SIFIs). ICBA has no position on the appropriate level of transparency and guidance or the accuracy of SIFI stress tests.

Q.5. I'd like to ask about House Financial Services Chairman Hensarling's legislation, the Financial CHOICE Act, which—in part—would allow banks to opt-out of various regulatory requirements, in exchange for meeting a 10 percent leverage ratio that is essentially the formulation required by the current Supplemental Leverage Ratio.

- What are the most persuasive arguments for and against relying upon a leverage ratio as a significant means of reducing systemic risk in the financial system?
- Under this legislation, is the 10 percent leverage ratio the right level? If not, where should policymakers set the level at?

- What evidence do you find or would you find to be the most persuasive in discerning the proper capital levels under this proposal?
- If the leverage ratio was set at the right level, do you find merit in eliminating a significant portion of other regulatory requirements, as with the Financial CHOICE Act? Are there any regulations that you would omit beyond those covered by the Financial CHOICE Act?
- What impact would this proposal have on liquidity in the marketplace?

A.5. The Financial CHOICE Act has not been introduced. ICBA is studying Chairman Hensarling's discussion draft. We strongly support the community bank regulatory relief included in the draft proposal.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SASSE FROM WAYNE A. ABERNATHY

Q.1.a. I'd like to discuss contingent convertible capital instruments, commonly known as CoCo bonds.

What lessons can be drawn from Europe's experience with CoCo bonds?

A.1.a. CoCo bonds, intended (particularly in Europe) to provide an alternative to immediate resolution of troubled or insolvent financial institutions, present significant practical problems that make their contribution to financial stability highly questionable and likely counterproductive. As the Bank for International Settlements has noted, designing triggers for the conversion of CoCo bonds into bank equity is highly complex. Triggers based on formulas, asset value tests, and similar measures are subject to problems of market opacity, potential manipulation, inconsistencies in application of accounting standards, and uncertainties when regulators exercise supervisory tools in relation to troubled institutions. Furthermore, in some structures the trigger is based on the institution's current market capitalization, which may be drastically affected by circumstances other than the condition of the institution itself, *e.g.,* general equity market conditions. Other structures rely on regulators' discretionary decisionmaking to trigger conversion. This approach introduces risk of inconsistent treatment of troubled financial institutions. All of these uncertainties and opportunities for arbitrary—or at least discretionary—regulatory action undermine market discipline. Indeed, these factors can also undermine market acceptability of the bonds, threatening the market's appetite for such instruments, which negative perception could become acute in times of general market stress. Resultant shortages of investors in CoCos, in turn, could accelerate retrenchment by banks unable to obtain regulatorily mandated supplies to support growth or even maintain current asset levels, hastening or intensifying financial recession.

Q.1.b. Do you believe CoCo bonds can uniquely help a firm withstand significant financial distress? If so, how?

A.1.b. The potential flaws in the mechanisms described above suggest that CoCo bonds would create more uncertainty and

unintended adverse effects than benefits for financial stability. Furthermore, the recent experience of European financial institutions that had issued CoCo bonds, the prices of which fluctuated dramatically based on confusion about the mechanics of the structures, offers no reassurance that these instruments are beneficial. Indeed, they suggest a limited availability of funds via CoCo bonds in good times and threaten a severe scarcity in times of stress, potentially rendering a bank unable to *maintain* regulatorily mandated levels of CoCo bonds and an impossibility of selling *more* to investors in order to support any *expansion* of lending related to economic recovery.

Q.1.c. How should Federal regulators treat CoCo bonds?

A.1.c. Federal regulators should bear in mind two considerations. First, some internationally active financial institutions with U.S. operations are regulated in jurisdictions that require or encourage CoCo issuance. If and when U.S. regulators are faced with resolution of one of these organizations, they will have to consider the impact of outstanding CoCo bonds on the U.S. operations, including any possible support this source of capital could offer to U.S. operations or, alternatively, the potential for ring-fencing and support offered to foreign operations but not to those in the United States. At a minimum, for each affected organization, U.S. regulators must understand the structure of the specific CoCo issuance(s) involved, how the bonds will behave in the circumstances, and the likely approach of foreign resolution authorities.

Second, Federal regulators have proposed a requirement for "total loss absorbing capacity" (TLAC), to be issued by the largest systemically important financial institutions. TLAC is intended to provide a capital injection when an institution's top-tier entity *becomes insolvent.* Though the industry has pointed out a number of problems and uncertainties with the proposal which the Federal Reserve must address, a modified TLAC proposal would likely be superior to CoCo bonds in at least this key respect: the equity conversion would take place in the context of a legal proceeding in which credit or claims, at least those at the top-tier entity, could be finally resolved under due legal process and with some degree of predictability, rather than as a mitigating step that could still be overwhelmed by adverse market conditions and regulatory judgment. Also, though initiation of resolution proceedings may involve some elements of regulatory discretion, there are detailed standards for both agency review and potentially judicial review of agency action. Those standards, already in place through legislation, contrast markedly with the questions that regulatory discretion and even arbitrariness present in the structure involving CoCo bonds and their triggers.

Q.2.a. I'd like to ask about Federal Reserve Governor Powell testimony at the April 14, 2016, Senate Banking Committee that "some reduction in market liquidity is a cost worth paying in helping to make the overall financial system significantly safer."

Is there also a risk that reducing liquidity in the marketplace also makes the marketplace unsafe?

A.2.a. Yes, decidedly so, and that is a risk that needs to be taken very seriously. We do not have to reject the purposes of measures

of prudential supervision to inquire whether they can be improved so as to operate better, and whether unintended consequences can be addressed. A market that is less liquid is one that is more fragile. Unless we are seeking the stability of the grave, we need rules and regulations that can accommodate the dynamics of living markets. As one of our member institutions described, market liquidity is the market's ability to function—to have buyers and sellers transact without causing sharp price moves. Can we have too much of that kind of liquidity, that is, better functioning markets? We do not believe so. Regulations that drive legitimate participants from the market, or significantly reduce their levels of participation, impair the liquidity and stability of the market place, compromising the ability of markets to perform their functions, increasing volatility and raising the chances of stressed markets seizing up for lack of ready participants.

Historically, banking organizations have provided liquidity to financial markets by acting as market makers, providing and encouraging the liquid operations of markets. This liquidity provision serves an important role in the depth and functioning of the financial markets that support so much other economic activity. Capital rules, such as a poorly designed and excessive leverage ratio, however, discourage market making in certain markets, such as those for Treasuries and corporate debt. In response, banking organizations are significantly decreasing or even exiting these and related activities, changing the structure of certain markets and making them less liquid and more volatile. We have recently heard that these measures are making it too expensive for some banks to take in business deposits, a key banking function. Where will those deposits go, and how does their departure from banking make the financial system more stable?

As another example, liquidity regulations such as the Basel-inspired Liquidity Coverage Ratio (LCR) mandate that banking organizations hold fixed ratios of "high quality liquid assets" (HQLA), dangerously limited to largely one asset class, Treasury securities. These rules, which govern how banks fund themselves and their customers' activities, are exacerbating the current dislocations in the Treasury market by taking significant portions of Treasuries out of circulation and significantly increasing demand for those that are traded. Further distorting the Treasury market are new rules raising collateral requirements for derivatives transactions, increasing demand for these same Treasury securities also demanded for use as HQLA. Under current market conditions while the economy is expanding, the stresses in the supply and liquidity of Treasury securities can be more potential than seen. But when economic conditions become more troubled, a lack of market liquidity will become acute, as those who hold HQLA will be reluctant to let go of their supplies, and those who need such Treasury securities—either for HQLA purposes or to use as collateral—will have difficulty finding supplies to meet their needs. The safety of the financial markets will become significantly tested in such times of stress. Liquidity of the instruments defined in regulation as HQLA may become only one-way liquid, easy to sell but hard to buy.

Robust capital and liquidity are essential to bank safety and soundness. Proper calibration of the rules that govern capital and

liquidity is essential for local, State, and national economic growth and prosperity. Banking organizations are essential economic actors, whose balance sheets reflect both individual business strategies and, in aggregate, economic decisions made across the products and services the banking industry provides to the U.S. economy and markets. It is imperative, then, that policymakers understand how the set of regulations applied to banking organizations affects U.S. financial markets and the economy. A stable and healthy economy needs access to financial products and services made available through smoothly operating markets.

Q.2.b. If so, how should regulators discern the difference between an unsafe reduction in liquidity and a safe reduction in liquidity?

A.2.b. For reasons described above, regulations that drive legitimate participants from the markets, or result in significantly curbing their activities, reduce the safety of the markets. This is not to countenance fraud, manipulation, and other forms of theft and dishonesty in the market place. Market liquidity is in fact enhanced to the degree that such illegal actors and their practices are removed from the markets. The concept of "safe reduction in liquidity" is a dangerous contradiction, however. The smoother the markets operate, the better. Introducing potholes, detours, and barriers into the function of the markets does not render them safer.

Q.3.a. I'd like to ask about the various capital requirements that have been imposed after the 2008 financial crisis.

Have Federal regulators sufficiently studied the cumulative impact—including on liquidity in the marketplace—of these various changes?

A.3.a. No, at least not yet. The banking agencies have not sufficiently studied the cumulative impact of various changes to the regulatory capital standards (or of other related prudential standards such as liquidity, resolution planning, stress testing, and risk management). Following the 2008 financial crisis the banking agencies issued various regulatory capital amendments, such as Basel III, heightened leverage ratio standards for large banks, and raised risk-based capital standards for large banks, among others. Each of these rulemakings contained minimal analysis of the impact, scant reference to the interaction with other regulatory standards, and in some cases analysis was provided only after the public comment period closed.

Internationally, the Basel Committee has issued a flood of recent proposals and final standards that, given their extent and impact, can best be named "Basel IV." Each of these proposals appears to have been developed in a silo, and ABA is very concerned that the Basel Committee lacks ability and incentive to evaluate the cumulative impact of the changes in an effective and transparent way. While the Basel Committee does conduct limited Quantitative Impact Studies (QIS) for individual proposals, the Committee does not seem to be able to connect the dots of the variety of prudential standards and how they interact.

We would emphasize that, when thinking about the cumulative impact of capital rules, it is also important to consider standards beyond the regulatory capital standards and their interplay in the economy. For example, heightened leverage ratio standards—which

measure all assets as if they posed identical risk—offer incentives to banks to hold less liquid assets, which of course runs against the purpose of the liquidity framework. There are many other examples, such as the effect of capital and liquidity rules together to punish banks for holding deposits.

Q.3.b. If not, how should Federal regulators resolve this issue? For example, some have called to delay the imposition of new financial rules and regulations, to facilitate a broader study of these issues.

A.3.b. We urge the regulators to begin a process of reviewing the significant prudential regulations to see how they can be simplified. We believe that the regulatory program of recent years has become too complex for regulator and regulated alike. In fact, we believe that the purposes of each can be enhanced by a review focused on what is actually needed. That simplification naturally leads to and *facilitates* a consideration of the interaction of the various rules. A reduction in the intricacy of these rules will improve their worth as supervisory tools for regulators and management tools for banks. With regard to capital rules, we would recommend asking which standards—indeed, which elements of the standards—provide the most supervisory and management value. Those of lesser value—not to say no value—should be considered for setting aside so as not to distract supervisory and management attention from standards that offer the most benefit.

As it relates to development of international standards, the regulatory agencies should conduct empirical studies of the impact on the U.S. banking system, with a focus on bank customers and the economy, that would result from the adoption of proposed international standards that are being considered for domestic implementation. While the Basel QIS process can be informative, that process is limited to a few banks and does not take into account U.S.-specific laws that might affect how a standard is implemented.

In order to support U.S. rulemaking efforts based on international standards, ABA believes that the banking agencies should conduct empirical cumulative impact studies as part of Advanced Notice of Proposed Rulemakings before a proposal is issued, as I discuss in my testimony. The results of the study would notify the public of the analyses underlying key elements of the agencies' determinations as is required under the Administrative Procedure Act and would allow the public to help identify the cumulative impact.

Q.4.a. I'd like to discuss stress tests. How should policymakers balance the tension between providing more transparency and guidance to regulated entities about how to pass a stress test, and concerns that to do so would allow regulated entities to allegedly "game" these processes?

A.4.a. *Surprise* is not an appropriate component of bank supervision. The very concept of bank supervision is based upon the principle of allowing banks to know clearly what is expected of them and supervising on that basis. Unfortunately, the excessive regulatory secrecy surrounding the preparation and administration of stress testing is itself suggestive of *supervisory* "gaming." Policy makers need not and should not compromise legal certainty in an effort to test banks' resilience. Besides basic fairness, wisdom and

good governance argue that those subject to a law must have the means of knowing what is required. Anything less is arbitrary and fertile for opportunities for abuse. Unfortunately, the stress testing regime is a secretive process that allows the Federal Reserve to adjust capital performance expectations without public discussion and oversight.

There certainly can be value in table-top "what-if" exercises, conducted jointly by banks and supervisors, to evaluate how both would respond to unexpected financial shocks, and learn from such hypothetical training drills. It is quite another matter to convert this approach into fully armed bank supervision, applying on the basis of surprise hypotheticals financial penalties that directly and materially affect banks, their investors, and the ability of banks to serve their customers. Under the current practice, with standards developed and hidden from public view, if a bank falls short in these stress tests severe and immediate penalties are assessed. In fact, the opaque stress testing standard has evolved to where it overshadows the regulatory capital standards that have been developed through the public and transparent process, subject to notice and comment under the Administrative Procedure Act. Serious questions of due process and wise supervision are raised. This secretive component in developing stress tests erodes public confidence in the supervisory process.

Regulations, stress tests, and other valuable supervisory tools should be so designed and administered as to promote safety and soundness. The standards of safety and soundness should not be shrouded in mystery. Safety and soundness rules should be sufficiently certain, clear, and well-known so that they provide those subject to them with the ability to conform their conduct. That is the desired result of a well-constructed program of bank supervision.

Q.4.b. Do stress tests accurately depict how a firm would perform during a financial crisis, when taking into account "systemic" considerations? If not, what should be done, if anything, to improve their accuracy?

A.4.b. No, not adequately. Stress test results are dependent on the plausibility of the scenarios. We believe that the scenarios have tended to be unrealistic, posing hypothetical economic and financial conditions far more severe than what can be reasonably expected. That might be tolerable if it were a question of whether a bank could endure such harsh scenarios. We note and appreciate how well banks have stood up under such harsh tests. The tests, however, become unreasonable when a bank's performance against such unrealities is used to govern a bank's actual activities *vis-a-vis* its customers and investors. Stress tests have been based on hypothetical scenarios and have relied upon a vast number of uncertain assumptions. Such stress tests can be useful in helping develop a bank's risk management systems and examining their tolerances, but that *usefulness* should not be confused with "accuracy" and applied to the real world services provided to customers and the earnings due to investors.

By definition, "accuracy" is not achievable in the stress tests, because that would require predicting the future. Moreover, if banks,

regulators, and other market participants ever become convinced that a stress test is "accurate," that would likely lead to over-reliance on the stress test modeling. "Effectiveness" in meeting the purposes of identifying issues and concerns for appropriate attention is a much better standard of measure, and effectiveness calls for a closer tie to reality understood by those being tested.

Q.5.a. I'd like to ask about House Financial Services Chairman Hensarling's legislation, the Financial CHOICE Act, which—in part—would allow banks to opt-out of various regulatory requirements, in exchange for meeting a 10 percent leverage ratio that is essentially the formulation required by the current Supplemental Leverage Ratio.

What are the most persuasive arguments for and against relying upon a leverage ratio as a significant means of reducing systemic risk in the financial system?

A.5.a. The leverage ratio has an important place in bank supervision, compensating for shortcomings in risk-based capital models and for risks that either cannot be measured or are unknown. It should be remembered, however, that the leverage ratio incorporates its own very obvious shortcomings, namely that it assumes that all assets carry the same risk all the time. That, of course, is a fiction, albeit a useful fiction as a *backstop* for the limitations of risk-based capital measures. Very wisely, the current supervisory capital program in the United States is one that relies upon a risk-based capital program with a leverage ratio backstop. That is the basic structure under which U.S. banks operate today, as required by statute.

That said, the draft legislation does not eliminate risk-based capital measures. As we understand it, the proposal offers an option. When a bank is extremely highly capitalized, the draft legislation would provide a simpler leverage ratio measure for calculating capital on the assumption, presumably, that at such high levels risk-based tests would be likely to be met.

Q.5.b. Under this legislation, is the 10 percent leverage ratio the right level? If not, where should policymakers set the level at?

A.5.b. Our primary concern is not with the level but with the calculation method. The draft legislation uses a complex calculation designed by the Basel Committee and used by large internationally active banks. As such, we believe it could be unnecessarily burdensome for community banks. We believe that a measure more appropriate for community banks for these purposes would be a leverage ratio based on United States Generally Accepted Accounting Principles (U.S. GAAP).

Q.5.c. What evidence do you find or would you find to be the most persuasive in discerning the proper capital levels under this proposal?

A.5.c. Any number that is chosen by law or regulation will be artificial, at best an approximation. Markets, however, tend to be more flexible. There is a natural tradeoff, when considering capital levels, between the two different types of investors in banks. Some invest in banks by taking equity positions, basically by providing capital. Others invest in banks by lending to banks, such as

depositors and holders of a bank's bonds and other debt instruments. The first group is compensated by the profits of the bank, which are subject to variation. The latter group is compensated by the stated terms of the interest rates applied to the debt.

It can be seen that there is a tension between the two. As capital requirements are raised, the profits per dollar of equity invested are reduced (spreading any given earnings among more units of investment), and capital investors may become harder to find, looking for better returns elsewhere. But raising capital levels increases confidence for those lending to the bank that the terms of the loans will be met, while reducing capital can make investors in debt harder to find or lead them to demand higher interest rates. Markets, if left to themselves, will balance those competing investor demands, consistent with the risk profile of the bank.

That is to say that, identifying a capital level set by governmental fiat is inherently difficult and likely to be inconsistent with the levels that markets may set. The questions that need to be asked, that can only be answered with imprecision, is at what level of capital will debt investors be unconcerned with regulatory standards that are waived (assuming that those regulatory standards add value to the performance of the bank), and will equity investors still invest in the bank at that level of dilution of their return on capital? The optimal answers to those questions are likely to vary by institutions and over time.

Q.5.d. If the leverage ratio was set at the right level, do you find merit in eliminating a significant portion of other regulatory requirements, as with the Financial CHOICE Act? Are there any regulations that you would omit beyond those covered by the Financial CHOICE Act?

A.5.d. The relevant question in examining any regulation is whether the regulation adds value. We would measure that value by the degree to which the regulation facilitates the ability of banks to serve their customers. Any regulation that inhibits the ability of banks to serve their customers needs to be revised or discarded.

We believe that this question should be applied to a review of regulations frequently, and that no regulation should be exempt from it. For example, we believe that the significant number of prudential regulations applied from the Dodd-Frank Act and those pursuant to global standards developed in Basel are generally far too complex for the good that they do. That is why in my testimony ABA urges that each of these regulations be subject to a public review and discussion as to how each can be simplified, which, in our view, will actually result in better supervision and achievement of the purposes of each regulation. That review would, in turn, serve the goal of facilitating the ability of banks to serve their customers, the reason why each bank in America was given a Government charter.

That process cannot be concluded in a day, and it has to start somewhere. We appreciate the selection of regulations that have been identified for review and reform in the CHOICE Act.

Q.5.e. What impact would this proposal have on liquidity in the marketplace?

A.5.e. As currently drafted, we do not anticipate any negative impact on liquidity. We are eager to work with the authors in the House as well as with those in the Senate working on regulatory relief measures to realize the intent of legislators to improve liquidity and the functioning of the financial marketplace. We believe that such efforts can achieve both better liquidity and better supervision.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

The Impact of Post-Crisis Reforms on the U.S. Financial System and Economy

Martin J. Gruenberg

Chairman

Federal Deposit Insurance Corporation

to the

Exchequer Club

Washington, D.C.

June 15, 2016

Thank you for the opportunity once again to speak to the Exchequer Club.

Today I would like to share some thoughts on the broader effects on the U.S. financial system and economy of the prudential safety and soundness reforms that the regulators have implemented since the financial crisis.

In response to vulnerabilities identified during the crisis, regulators have undertaken a series of measures to strengthen the banking system of the United States and promote a more stable and resilient financial system. The federal banking agencies have strengthened the quality of regulatory capital and increased the level of risk-based capital requirements for all banks, and have established enhanced leverage ratio requirements for the largest, most complex banking organizations. The banking agencies also have finalized requirements for increased liquid asset holdings of large banking organizations, proposed liquidity rules addressing the need for longer-term stable sources of funding, and worked with other agencies to establish margin requirements for non-cleared derivatives and limit the use of the federal banking safety net to support proprietary trading. The Federal Reserve's CCAR stress test process[1] has significantly increased the focus on rigorous management of the risks at large banking organizations.

As an objective matter, the banking system is significantly more resilient today as a result of these reforms. At the end of 2015, large banking organizations[2] had twice as much tier 1 capital and liquid assets in proportion to their size as they had entering the crisis,[3] and the loss-

[1] Comprehensive Capital Analysis and Review.
[2] Bank Holding Companies with assets of at least $250 billion.
[3] The tier 1 leverage ratio for BHCs with assets of at least $250 billion increased from 4.46 percent at year-end 2007 to 9.04 percent at year-end 2015, while the ratio of liquid assets (for this purpose these consist of cash, Fed Funds sold, Treasury securities, Agency debt securities, and Agency mortgage-backed securities) to total assets increased from less than 10 percent to about 21 percent during the same period.

absorbing quality of their capital has greatly improved. The quality and level of capital at smaller banks is stronger today as well.

It is fair to ask how these prudential reforms have affected banks' ability to support U.S. economic growth and market functioning. In this regard, four broad areas are often mentioned. These are credit availability, bank profitability, market liquidity, and the distribution of financial activity between banks and nonbanks. Today I would like to discuss all four of these areas. To cut to the chase, I believe the evidence suggests that the reforms put in place since the crisis have been largely *consistent with, and supportive of*, the ability of banks to serve the U.S. economy.

Credit Availability

With that as an introduction, I will turn to the first area, credit availability. How the post-crisis reforms have affected the willingness of banks to lend is an important question. What we observe is strong loan growth at U.S. banks. Loans on the balance sheets of insured banks are increasing significantly faster than economic growth and faster than some important measures of household and business credit. For example, in 2015 loans held by insured banks grew 6.4 percent, more than twice as fast as Gross Domestic Product. One-to-four family mortgages, meanwhile, grew 3.4 percent, more than twice the rate of growth of household residential mortgage debt from all sources,[4] while commercial and industrial loans grew 7.4 percent, exceeding the 4.3 percent growth of the outstanding amount of corporate bonds.[5]

[4] Household home mortgage debt excluding home equity lines; data from Federal Reserve Flow of Funds.
[5] Outstanding balances of corporate bonds as reported at http://www.sifma.org/research/statistics.aspx.

As reported in the FDIC's most recent Quarterly Banking Profile, loan growth at insured banks was even stronger at the beginning of 2016 than last year. As of the end of the first quarter, loans exceeded their year-ago levels by 6.9 percent for all insured banks and by 8.9 percent for community banks. For FDIC-insured banks as a whole, loan portfolios experienced the fastest 12-month growth rate since the crisis. Not only has loan growth been substantial in aggregate, it has been widespread across banks. As of the first quarter, approximately eight out of ten FDIC-insured banks had grown their loan portfolios from the levels of a year earlier, the highest proportion of banks with such growth since before the crisis (Chart 1).

A look at broad trends over time suggests that the most important driver of bank lending is the business cycle and the credit needs of businesses and households. Bank lending and the total debt of households and businesses grew rapidly during the run-up to the crisis, and then declined during the crisis and for a few years after. The retrenchment from the crisis is largely over, and bank loan growth and risk appetite appear to have returned (Charts 2 and 3).

Bank lending trends should be evaluated relative to a regulatory goal of promoting a healthy and sustainable climate for access to credit that does not endanger stability or unduly expose the Deposit Insurance Fund or taxpayers. A well-functioning banking system provides neither insufficient credit, nor an unsustainable volume of poorly underwritten credit that can never be paid back. What we are seeing now is stronger capital at U.S. banks and substantial loan growth. The growth of loans on bank balance sheets is outpacing GDP growth and the growth of some important measures of household and business credit. Such comparisons reinforce the picture presented by Call Report data, that U.S. banks are full participants in funding the growth of credit to our economy. Looking ahead, when the next economic downturn

arrives, U.S. banks will be more resilient and better positioned to support the credit needs of the economy.

Bank Profitability

The next topic I want to discuss is banking industry profitability.

Bank earnings have improved during the post-crisis period in the face of some significant headwinds. FDIC-insured institutions earned nearly $164 billion in 2015, a new record. Almost two-thirds of all institutions reported higher earnings in 2015 than in 2014. Only eight institutions failed last year—the lowest number since 2007.

A 1.9 percent reduction in banking industry earnings during the first quarter of 2016 was driven by increased provisions for energy-related loans and reductions in trading revenue at a few large institutions. First quarter earnings were noteworthy for the continued strong performance of community banks. Their net income grew 7.4 percent compared to first quarter 2015 levels, and year-over-year loan growth at community banks of 8.9 percent outpaced the loan growth of larger banks.

The most important earnings headwind for banks of all sizes during the post-crisis period has been reductions in net interest margin. Net interest margin for insured banks with assets greater than $250 billion declined from 3.3 percent in 2010 to 2.7 percent as of the first quarter of this year. For all other insured banks, the comparable decline was from 4.2 percent to 3.5 percent. Community banks have seen relatively less erosion of net interest margin than other banks during the post-crisis period.

Banks have faced other significant earnings headwinds as well, some of which have been more pronounced for the largest banks. Many banks worked off significant volumes of noncurrent loans during the post-crisis period, and for most banks, this process is largely complete. The largest banks have also reduced their noncurrent loan volumes considerably, but still have noncurrent loans exceeding pre-crisis levels. For insured banks with assets greater than $250 billion, noncurrent loans stood at 2.1 percent of loans as of first quarter 2016, compared to 0.8 percent of loans at the end of 2006. Litigation expenses, although recently moderating, subtracted nearly $100 billion from the bottom lines of the eight U.S. Global Systemically Important Banks from 2010 through 2015.[6]

Reported noninterest expense, or overhead, has generally trended downward on bank Call Reports. For example, for insured banks with assets greater than $250 billion, non-interest expense averaged 3 percent of average assets during the five pre-crisis years of 2002 through 2006, and 2.76 percent of average assets during the five post-crisis years of 2011 through 2015. Smaller banks also reduced their non-interest expenses, from 3.16 percent during the pre-crisis years to 2.99 percent during the post-crisis years.

In summary, despite significant headwinds, bank earnings have been on a generally favorable trajectory as we move farther from the crisis. The major earnings headwinds during the post-crisis period have been compression of interest margins, the working off of high levels of non-current loans coming out of the crisis, and for the largest banking organizations, litigation expenses. The improvement in bank earnings reflects a return to profitable banking, but with capital levels that are better able to absorb losses than was often seen during the pre-crisis years.

[6] Based on data from form Y-9c; litigation expenses are specifically reported only if the amounts exceed 3 percent of noninterest expense or $25,000.

Market Liquidity

The next topic I would like to address is market liquidity. Questions have been raised about whether the post-crisis reforms have caused a pullback from market-making activity by bank-affiliated broker-dealers, and whether this in turn has hurt market liquidity. Much of this discussion has centered on the secondary market liquidity of corporate bonds and U.S. Treasury bonds.

I want to touch on three distinct sets of questions regarding market liquidity. First, how do the goals of prudential banking regulation relate to a goal of promoting market liquidity? Second, what important factors have affected the activities of bank-affiliated broker-dealers? And third, whatever may be driving changes in broker-dealer activity, what have been the effects on market liquidity?

Question one is the most fundamental: How does market liquidity relate to what we are trying to accomplish as prudential regulators? The pre-crisis liquidity of financial markets was abundant, but it vanished during the crisis with devastating effects. It is worth remembering that between 2003 and 2007, the five largest U.S. investment banks doubled in size before they all failed, merged, or became bank holding companies. Insufficient capital and liquidity that was dependent on readily available short-term wholesale funding made these firms especially vulnerable to distress, and they became transmitters of financial instability.

The intention of the post-crisis reforms was to reduce the extent of financial leverage and reliance on short-term wholesale funding of large banking organizations. Effective prudential regulation should help promote *sustainable* liquidity conditions through time. Strong financial institutions that are better protected against losses, and less vulnerable to runs, should better

insulate the financial system against a catastrophic failure of liquidity such as the one that occurred in 2008.

A second set of issues that frequently arises in discussions of market liquidity relates to changes in broker-dealer balance sheets and what is driving those changes. In aggregate, there has been a reduction in the size of broker-dealer balance sheets in recent years, which has included a reduction in bond inventories and in the volume of short-term repurchase agreements (repo) that are an important source of financing for those inventories.

One factor that may be influencing balance sheet decisions at bank-affiliated broker-dealers is the need for their parent banking organizations to have adequate consolidated capital and liquidity. The experience of the crisis is a reminder of how important this is.

Since questions have been raised about the drivers of balance sheet decisions at broker-dealers, I would like to touch briefly on some of the other factors that may be at work.

One important change affecting broker-dealers in recent years has been the effective elimination of their access to intra-day credit from the clearing banks in the tri-party repo market. This curtailment of intra-day credit was one of the explicit goals of a multi-year initiative to reduce systemic risk in the repo market under the leadership of the Federal Reserve Bank of New York.[7]

The size of broker-dealer balance-sheets may also be influenced by the risks of holding bonds. Bonds with very long maturities would experience potentially significant losses in value

[7] Task Force on Tri-Party Repo Infrastructure, Payments Risk Committee, Final Report, February 15, 2012; and https://www.newyorkfed.org/banking/tpr_infr_reform.html.

in a rising interest-rate environment. Credit risk also appears to be increasing for some bonds, especially for selected energy or other high-yield obligations.

Another post-crisis development is that central banks around the world, pension and retirement funds, and mutual funds have greatly increased their holdings of Treasury bonds and other high-quality assets. Some observers believe the result has been a scarcity of Treasury collateral and other high-quality collateral that has reduced the size of the repo market, a market that is important to broker-dealers.[8]

Finally, the profit margins or "bid-offer spreads" that broker-dealers earn on buying and selling bonds generally have been trending downward since the crisis. Some research suggests this may reflect a more competitive trading environment and improvements in technology.[9] Lower bid-offer spreads make buying and selling bonds less profitable, and may be part of the reason broker-dealers are reportedly trading more bonds "as agent" instead of holding inventories.

This brings me to the third question about market liquidity. Whatever the reason for changes in broker-dealer balance sheets, what has been the resulting effect on the market liquidity of bonds?

A number of published analyses over the past year have attempted to shed light on whether, or in what way, corporate and Treasury bond market liquidity have deteriorated.

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[8] Bednar, W. and M. Elamin, "What's Behind the Decline in Tri-Party Repo Trading Volumes?" Federal Reserve Bank of Cleveland, online "Economic Trends" series, April 2014; and Munyan, B., "Regulatory Arbitrage in Repo Markets," OFR Working Paper 15-22, October 29, 2015.

[9] Mizrach, B., "Analysis of Corporate Bond Liquidity," Research Note, FINRA Office of the Chief Economist, October 2015.

Published research[10] documents a number of changes in corporate bond trading during the post-crisis period, including, among other things, the following: an increasing number and dollar volume of corporate bond trades, decreasing cost to trade as indicated by narrower bid-offer spreads and a reduction in the impact on bond prices resulting from large trades, smaller trade sizes, greater retail participation, and a significant increase in market participant use of electronic platforms to conduct some of the tasks involved in trading. The research cites a survey indicating that the top ten U.S. dealers now account for a larger percentage of corporate bond trades by dollar volume than in 2007. Overall, what this research seems to be describing is less a retreat from market making than a change in the way it is conducted: that is, lower transaction costs, more frequent and smaller trades, and more trades conducted as agent or on order rather than as principal.

For Treasury bonds, research documents strong liquidity conditions, including extremely narrow bid-offer spreads and high trading volumes. A noteworthy finding of an interagency staff report by five federal agencies is the significant volume of trading of Treasury bonds in the United States that occurs on high-speed electronic platforms.[11] As the report noted, trading on such platforms can sometimes exhibit anomalous behavior that is worthy of the attention it is receiving from regulators.

In conclusion, recent research does not seem to support the proposition that post-crisis market liquidity for bonds has declined and in fact describes improvement in a number of standard measures of liquidity. This could certainly change under more stressful conditions, but

[10] See, for example, Mizrach, op. cit., and Liberty Street Economics Blog Posts, various authors, series on Market Liquidity, August 2015, October 2015, and February 2016, Federal Reserve Bank of New York.
[11] U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, U.S. Securities and Exchange Commission, U.S. Commodity Futures Trading Commission, "Joint Staff Report: The U.S. Treasury Market on October 15, 2014," July 13, 2015.

stronger and more resilient banking organizations should make the economy and financial system as a whole better able to navigate such conditions and less prone to a collapse in market liquidity.

Migration of Financial Activities to Nonbanks

Finally, I would like to discuss the idea that the post-crisis reforms may be changing the distribution of financial activity between banks and nonbanks, in some way making banks less important financial players than before.

For many years before the financial crisis, the loan holdings, and more broadly, the financial asset holdings of U.S. insured banks did, in fact, decrease steadily relative to the holdings of nonbanks. According to the Federal Reserve's Flow of Funds data, during the three decades leading up to the financial crisis, U.S. banks' share of the total loans held by the domestic financial sector decreased from 68 percent to 35 percent.[12] Similarly, from 1975 through 2000, banks' share of the total assets—including both loans and other financial assets—of the domestic financial sector decreased from 40 percent to about 16 percent. Broadly speaking, these reductions in banks' share corresponded to a significant increase in the proportion of loans in the financial system held by Government-Sponsored Enterprises (GSEs) and securitization vehicles, and a significant increase in the proportion of total financial assets held by investment funds, GSEs, securitization vehicles, and broker-dealers.

[12] "Banks" refers to "U.S. chartered depository institutions," reported in Federal Reserve, Flow of Funds table L.111. These data are for consolidated FDIC-insured depositories excluding foreign branches and foreign subsidiaries. The figures cited for banks' share of loans are for year-end 1975 and year-end 2006.

If the post-crisis reforms were diminishing the role of banks in financing the credit needs of the U.S. economy, one would expect the pre-crisis migration of lending and assets to nonbanks to have continued or accelerated. Yet the data that showed declining market share for banks before the crisis, show that trend coming to a stop or reversing during the post-crisis period. The share of domestic financial sector assets held by banks has held steady at about 16.5 percent since 2010. And banks' share of total loans held by the domestic financial sector, having fallen steadily by about 34 percentage points during the three decades before the crisis, has *increased* by about five percentage points since 2010 (Chart 4).

The increase in banks' share of lending and their steady asset share may seem surprising given the increasing role played by nonbanks in some segments of financial services. For example, corporations have taken advantage of low interest rates since the crisis by issuing bonds in large amounts. A considerable portion of these bonds are held by mutual funds, which now hold a greater proportion of the assets of the U.S. financial sector than in 2010. Banks' steady share of financial assets since 2010 means that their overall asset holdings have expanded during this time at the same rate as the asset holdings of the U.S. financial sector—that is, not as fast as the assets of mutual funds, but faster than the assets of a number of other sectors such as money market mutual funds, finance companies, securitization vehicles, and broker-dealers. It is also worth mentioning that vigorous corporate bond issuance does not completely bypass large banking organizations as financial services providers, since they earn revenue by underwriting large amounts of these bonds.[13]

[13] Data on the volume of debt and equity underwritten by selected large banking organizations are available on Federal Reserve form FR Y-15.

The environment for lending has not been static either. In leveraged lending, there appears to be increasing involvement by nonbanks, although often in these situations a bank will be providing financing to the nonbank. In residential mortgage lending, the share of originations made by entities that are not affiliated with banking organizations has increased significantly. These nonbanks, however, are not typically the ultimate providers of credit. They are often financed by banks, and they generally attempt to promptly sell the mortgages they originate, most often to GSEs and sometimes to banks. The data seem to be telling us that notwithstanding such evolution in lending activity, banks' role as ultimate holders of the credit risk of loans has become more important in the post-crisis period.

Given the substantial recent bank loan growth I described earlier, it is not surprising that banks' share of loans held by the U.S. financial sector has increased. In aggregate, the five percentage point increase in banks' loan share roughly corresponds to the post-crisis reduction in the share of loans held by securitization vehicles. Banks' offloading of loans through securitization before the crisis was one of the factors driving their reduced share of loans relative to nonbanks, and was arguably driven by the desire to avoid bank capital charges. Now, while bank capital requirements have been strengthened, the data suggest banks are financing credit relatively more with their balance sheets and relatively less with securitizations.

I will end this discussion of the distribution of financial activity between banks and nonbanks by coming full circle, back to the point about the increasing capital strength of banks. U.S. bank balance sheets today are financed to a greater extent with equity capital and are better able to absorb losses. Banks are using their strong balance sheets to support significant loan growth to businesses and households. The relative importance of bank balance sheets as the

ultimate holder of the credit risk for loans, which had been decreasing for many years before the crisis, is now increasing.

Conclusion

In conclusion, the economic environment remains challenging for U.S. banks, with narrower net interest margins and modest overall economic growth. Nevertheless, I think an objective look at relevant data suggests that on balance, the reforms that have been put in place since the crisis have made the financial system more resilient and more stable, while strengthening the ability of banking organizations to serve the U.S. economy.

Chart 1

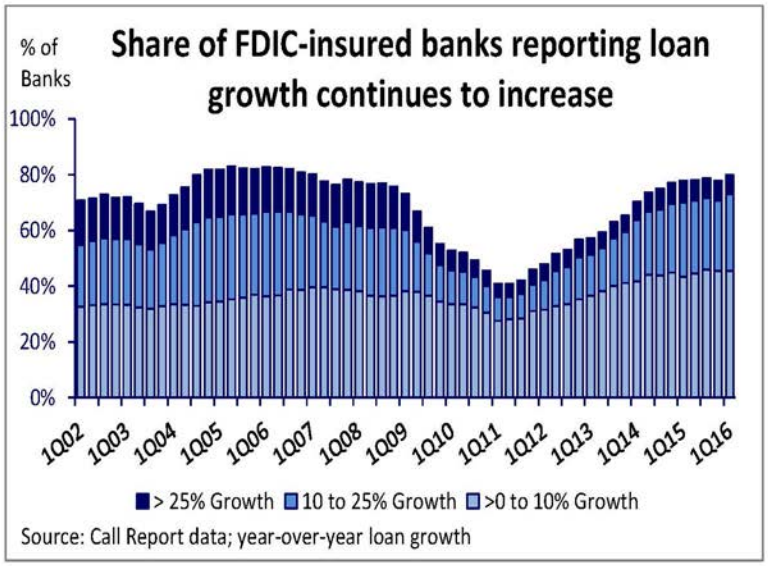

Share of FDIC-insured banks reporting loan growth continues to increase
% of Banks
100%
80%
60%
40%
20%
0%
1Q02
1Q03
1Q04
1Q05
1Q06
1Q07
1Q08
1Q09
1Q10
1Q11
1Q12
1Q13
1Q14
1Q15
1Q16
> 25% Growth
10 to 25% Growth
>0 to 10% Growth
Source: Call Report data; year-over-year loan growth

Chart 2

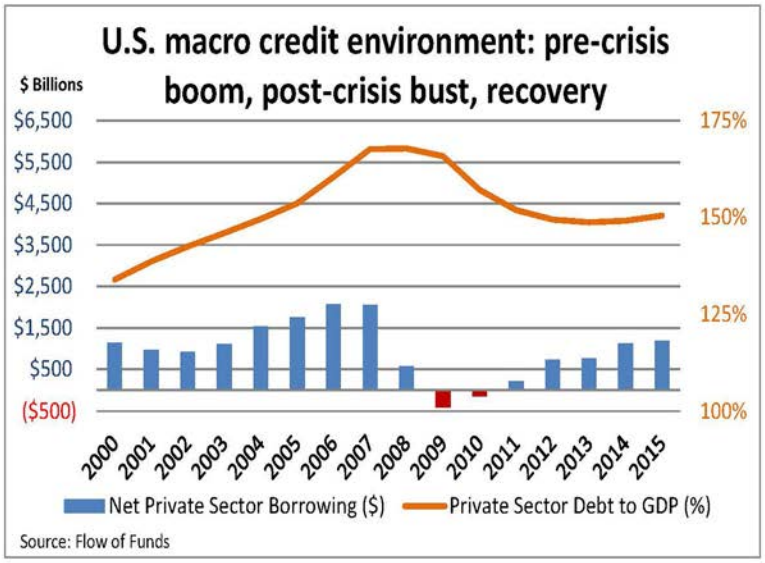

U.S. macro credit environment: pre-crisis boom, post-crisis bust, recovery
$ Billions
$6,500
$5,500
$4,500
$3,500
$2,500
$1,500
$500
($500)
175%
150%
125%
100%
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
Net Private Sector Borrowing ($)
Private Sector Debt to GDP (%)
Source: Flow of Funds

Chart 3

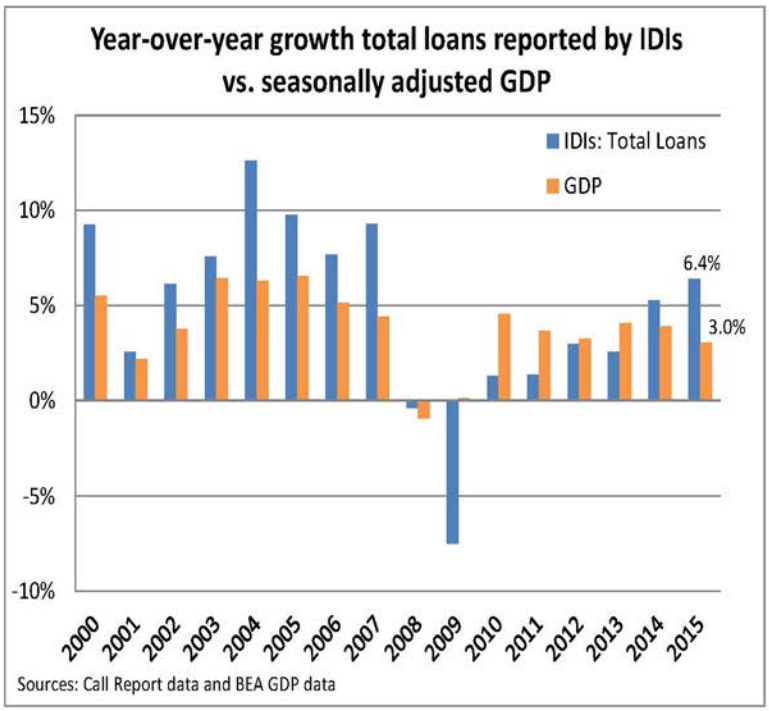
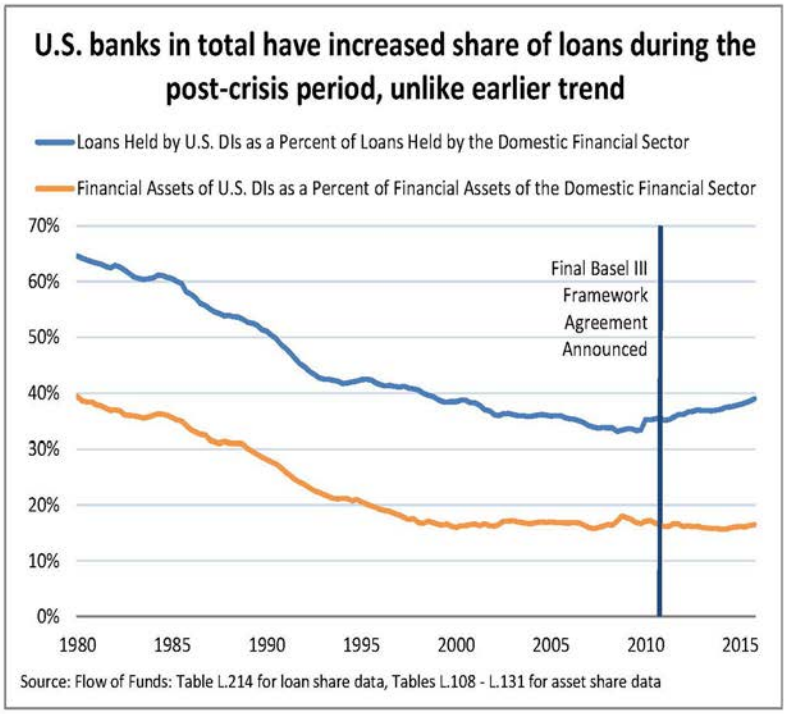

Year-over-year growth total loans reported by IDIs
vs. seasonally adjusted GDP
15%
10%
5%
0%
-5%
-10%
IDIs: Total Loans
GDP
6.4%
3.0%
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
Sources: Call Report data and BEA GDP data

Chart 4


U.S. banks in total have increased share of loans during the post-crisis period, unlike earlier trend
Loans Held by U.S. DIs as a Percent of Loans Held by the Domestic Financial Sector
Financial Assets of U.S. DIs as a Percent of Financial Assets of the Domestic Financial Sector
70%
60%
50%
40%
30%
20%
10%
0%
1980
1985
1990
1995
2000
2005
2010
2015
Final Basel III Framework Agreement Announced
Source: Flow of Funds: Table L.214 for loan share data, Tables L.108 - L.131 for asset share data